National Tooling & Machining Association

NTMA

PRECISION

Business Management Advisory

For Precision Custom Manufacturers

AC08 **File: ACCOUNTING AND FINANCE**

PLANNING YOUR EXECUTIVE COMPENSATION

SUMMARY

The amount of compensation paid to owners and managers in the tooling and machining industry varies widely, depending both on responsibilities and on results. Although there is no single method for calculating the "right" amount of executive compensation, business owners should consider certain key factors when determining the appropriate financial reward for themselves.

Executive compensation should be a part of your company's planning process, not simply a snap decision based on your cash balance at year end. Your firm's ability to grow and maintain a sound financial structure depends on finding the right balance between executive compensation and retained earnings. In addition, the Internal Revenue Service and other parties (such as minority shareholders or your spouse in a divorce action) may take issue with your level of compensation under a variety of circumstances.

Regardless of your company's legal form of organization (proprietorship, partnership, subchapter S corporation or ordinary corporation), you should establish a base salary for owners as well as employees. This amount distributed throughout the year, will provide you with a consistent figure for budgeting and cash flow planning. At year end, or even at the end of each quarter, you can review your operating results to determine whether executive bonuses have been earned.

Before paying bonuses, however, you should review your company's basic financial structure and your plans for the future. What amount of net worth (owners' equity) will you need one year from now to support your projected sales and assets? Are you planning a significant expansion beyond that time, perhaps three to five years in the future? If so, at what rate should your company retain earnings to make such expansion feasible?

A rough "rule of thumb" regarding sales growth and retained earnings is this: your debt structure will remain the same if the net worth is increased at the same rate that sales volume is expected to grow—provided that your asset utilization is unchanged. In other words, your total liabilities (what your company owes to suppliers and other creditors) will continue to be the same proportion of net worth (the owners' investment in the company) as long as management is successful in two actions: (1) adding retained earnings to net worth at the same rate that sales are increased, and (2) holding the growth of total assets to the same rate that sales are increased.

Obviously, increasing net worth through retained earnings is a critical factor that shapes your company's financial structure. To ignore the need for retained earnings when deciding on the amount of bonuses to be paid to executives could result in crippling your company and reducing—or even eliminating—future compensation.

In addition to considering your company's financial requirements, you should be aware that other parties may take a particular interest in the level of compensation paid to executives. Disagreement on this issue may lead to a lawsuit alleging "unreasonable compensation."

In such an action, someone—a minority shareholder, a passive partner, a family member, or the IRS—claims that the principal owners have paid themselves more than was necessary or customary for the responsibilities involved. The complaining party asserts that a portion of the compensation received by the majority shareholders was, in reality, company profit. Such "excessive" or "unreasonable" compensation is alleged to be "return on capital" that should have been retained in the company (thus increasing the book value of the business) or should have been paid to shareholders in the form of dividends. Minority shareholders and family members may demand either higher retained earnings or higher dividends, while the IRS seeks to reduce executive compensation and increase dividends in an effort to tax both the profit earned by the company and the dividends received by the owners.

Factual situations which may trigger claims of unreasonable compensation include:

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- large increases in compensation of top executives (particularly majority shareholders),
- bonuses that represent a high proportion of base salary,
- executive compensation significantly higher than the norm for businesses of similar size,
- consistently low net profit during years of comparatively high executive compensation, or
- failure to pay dividends during years when executive compensation was raised.

An important factor in a successful defense against such claims is proper documentation of the basis for increasing executive compensation. Of equal importance in any serious dispute (particularly if the case goes to court) is industry data which shows how the company's compensation and profitability relate to the performance of comparable firms—and why the company's specific situation justifies its compensation level. Interpretation of the industry data and the firm's comparative performance by an expert witness can significantly increase the credibility of the company's position.

NTMA's Operating Costs and Executive Compensation Report is widely regarded as the most complete source of information about the contract metalworking industry. Because owners of tooling and machining companies are generally paid more than owners of standard manufacturing firms, the annual industry report usually represents a comparatively high (and therefore favorable) benchmark for evaluating executive compensation. Consequently, it can provide an immediate first line of defense against a case built on general-purpose compensation reports, such as those published in business magazines or distributed by accounting firms.

To minimize the sudden appearance of problems in the future, every business owner should make an annual review of his company's competitive position with respect to profitability, financial structure, and executive compensation. Following that review, the minute book or other company records should state clearly the basis for determining executive compensation—particularly if compensation is comparatively high, or represents a significant increase over the previous year, or consists largely of a cash bonus.

Because the reasonableness of executive compensation is judged in relation to a company's total performance, no single factor can be relied upon to justify a specific level of compensation. There are, however, certain elements that should be reviewed and included in written documentation whenever they serve to support executive pay. Among these factors are direct (for example, selling or engineering) activities or indirect (managerial) actions which resulted in increased sales, reduced costs or improved asset utilization.

In documenting the reasons for increasing or decreasing executive compensation, emphasis should be placed on specific activities and achievements of management, rather than on the company's profit level. It is important to avoid the impression that executive compensation is simply determined by the availability of funds (which would support opposing claims that much of executive compensation is, in actuality, profit attributable to shareholders' capital and should have been retained in the company or distributed as dividends). Certain profit goals, such as "return on assets" or "return on equity," may be useful for determining bonuses, but these standards should be used with caution.

As an additional approach, the declaration of a small dividend on common stock when profit is higher than normal may help to show that management recognizes that distinction between executive compensation and "return on capital."

You should discuss your compensation plans, in detail, with your accountant on a regular basis. If any dispute involving executive compensation should arise, see your accountant and lawyer at once. Prompt action may prevent substantial legal expense and lead to a more favorable outcome. In matters of executive compensation, the downside risk may be equal to several years of personal income.

UNREASONABLE ACCUMULATION OF EARNINGS

Owners and managers of mature companies must also consider the other side of the issue of executive pay: a low level of compensation relative to retained earnings. The low end of the executive compensation range is, as a general rule, not advantageous unless your company has a clear plan for the use of retained earnings.

From a personal perspective, most company owners prefer to enjoy comparatively high executive compensation. In addition, there are three reasons why passing up executive compensation in favor of very high retained earnings may cause problems:

(1) The company may not be capable of generating a sufficient "return on equity." That is, the company may not produce an adequate net profit on the comparatively high level of net worth (which results from unusually high retained earnings). In that case, the owners are giving up additional income they would have received if their excess net worth had been invested in other financial instruments (from government bonds to mutual funds) or even real estate.

(2) In the future, prospective buyers of the company may be unwilling to pay more than book value (adjusted for appraisal of fixed assets) for the company because the "return on equity" has been unsatisfactory.

(3) In extreme cases, the IRS may file a claim of "unreasonable accumulation of earnings" against the company, alleging that earnings were retained to avoid taxation of shareholders (who, from the IRS viewpoint, should have received a portion of those earnings in the form of compensation or dividends).

Even if "return on equity" is adequate and no IRS challenges materialize, developing a diversified personal portfolio is usually a better approach to retirement planning than is the concentration of personal wealth in a single company.

Paying out greater executive compensation or dividends might enable the owners to establish a separate corporation which would purchase the plant (and possibly certain equipment) now owned by the company and lease back those assets. Such an arrangement might provide tax advantages and might facilitate sale of the company and reduce estate problems in the future. The advice of your accountant and/or your lawyer should, of course, be sought before making any such move.

The usual reason for deferring current income (holding down today's compensation) and thereby increasing retained earnings is to receive capital gains from the sale of the business at a time in the future when the owner will not be earning direct compensation from the company. Because it is impossible to predict future events, no one can say whether changes in the tax laws, interest rates, price levels, the national economy, the exchange rate of the dollar, or personal factors will cause that strategy to be advantageous in the long run. This uncertainty factor appears to support the concept that a company should retain earnings sufficient to support anticipated sales growth and pay the remainder (if any) in executive bonuses, to be spent or invested as the owners' personal circumstances might suggest.

This BMA was prepared by Barry E. Miller, Financial Management Consultant, Reading, PA. The Barry E. Miller Company prepares the Operating Costs and Executive Compensation Report and the Wage and Fringe Benefit Report for NTMA. Mr. Miller serves as a consultant to NTMA members and has appeared as an expert witness on behalf of member companies.