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Distinguishing Owner Compensation from Profit in Closely Held Companies: In Search of a Responsibility Premium

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Income valuation methods posit that a closely held company’s stock value is determined by the future expected free cash flow it will generate, divided by a capitalization rate appropriate to the level of investment risk. Alternatively, if a reliable forecast of expected returns can be broken into discrete periods and a terminal value, a discounting process can be used.

The free cash flow represents the cash available to the investor after all operating expenses of a business have been satisfied. Business operating expenses include compensation, whether or not paid to an owner. If cash paid to an owner represents a legitimate operating expense, it is not included in the free cash flow used to measure value.

In many business valuation contexts, the distinction between free cash flow and owner compensation is clear. For example, cash returns on an investment in a publicly traded equity clearly represent free cash flow or profits, not wages, because the typical investor supplies no labor to the invested company, and returns are independent of any exertions on the part of the investor. There is, however, a problem in applying income valuation methods to small, closely held firms where the owner contributes equity and significant services to the enterprise. In these cases, an analysis of the cash flows available to the owner must be made to determine what portion represents a reasonable return for services (that is, wages), and what portion represents a return on equity (that is, profit or free cash flow). With income valuation models, only the latter drives value.

Income valuation models call for using a substitution approach to allocate income between compensation and profit. I will argue that while the substitution concept is sound in principle, its application in practice is very problematic. Specifically, the widely recommended approach to allocate owners’ income between wages and free cash flow usually will result in an understatement of true substitution cost. Full substitution cost requires the addition of a premium to compensate owner-employees for accepting the entrepreneurial burden of operating a closely held business. I call this additional compensation a responsibility premium. Unfortunately, neither existing databases nor any that could easily be developed are capable of providing a reliable estimate of what this responsibility premium should be.

Wages vs. Profit: No Trivial Issue

The allocation of income between wages and profit is often the most contentious issue in valuation cases, because it has the greatest material impact on appraised values. Example. Paula Hubbard is the sole owner of a long-established and highly successful custom cabinet business, Mother Hubbard’s Cupboards, Inc. She and her husband...
are divorcing. Her equity interest in the business is considered a marital asset, and valuation analysts representing both parties have been engaged to value the business.

In addition to managing the S corporation, Paula also works as a skilled cabinetmaker. Her annual hours are 1,100 hours for carpentry and 1,300 hours for management. In recent years the business has generated on average $120,000 of income available to the owner after third-party operating expenses. To reduce the payroll tax burden, the company’s accountant classified $40,000 as wages and $80,000 as profit.

The husband’s valuation analyst argues that the tax return allocation is reasonable. Paula’s analyst argues that this allocation is not accurate, and that a more reasonable allocation would be exactly the reverse, that is, $80,000 as wages and $40,000 as profit. Both analysts agree that a capitalized earnings valuation approach is reasonable and that a capitalization rate of 20 percent is appropriate. Thus, the husband’s analyst derives an equity value of $400,000 ($80,000 ÷ 0.2), while Paula’s analyst derives a value of $200,000 ($40,000 ÷ 0.2). The $400,000 disagreement in the classification of income between wages and profit leads to a $200,000 disagreement in the valuation of the equity interest.

The Substitution Approach

Proponents of income valuation methods recommend a substitution approach to distinguish between profit and compensation, i.e., the allocation of available income between wages and profits. Pratt, Reilly, and Schweihrs describe the process this way:

The general idea of the compensation adjustment is to substitute the cost of hiring and paying a non-owner employee for the compensation actually paid to the owner to perform the same function. Another way to look at it is to compare the actual compensation paid to some average amount that other people normally are compensated for performing similar services.¹

Implicit in this concept is the idea that if the total cash and benefits received by the owner-employee exceed the total compensation that would be paid to the comparable non-owner employee, the excess is characterized as free cash flow or profit.

The substitution approach is based on the premise that a non-owner employee can replace an owner-employee. In the context of most small closely held businesses this is a false premise. Generally, owner-employees assume indispensable functions and responsibilities that non-owner employees would be unwilling to accept without significant increases in compensation.

The indispensable functions and responsibilities performed by owner-employees are of two related kinds. First, in most small, closely held firms the owner-employee performs multiple functions, while non-owner employees are more likely to perform specialized duties. Second, an owner-employee assumes a fiduciary responsibility for the business that non-owner employees are simply unlikely to assume (absent an ownership interest).

These additional fiduciary responsibilities involve safeguarding business property and records; maintaining business reputation with customers, vendors and creditors; and an overriding commitment to the success of the business. In small, closely held businesses only the active participation of an owner will insure that these responsibilities are adequately met. Without this active owner participation, most small enterprises would fail. Additional compensation for bearing these extra burdens and making more extraordinary sacrifices is required. This additional compensation should not be confused with the profits or free cash flow received by uninvolved investors.

Certainly diligent, honest, and competent non-owner employees can be found to fulfill management tasks. However, in most circumstances attempting to substitute non-owner employees for owner-employees will lead to severe agency problems with disastrous consequences for the survival of the business. Agency problems result from the difficulty of aligning employees’ and owners’ interests. Employees are hired to act in the owner’s interests, but often they will act in their own interest to the detriment of the owner if they are not adequately supervised. Agency problems are serious for firms of all sizes, but are more severe for smaller closely held companies than for larger ones.

The Multi-function Problem

Most owners of small, closely held businesses perform multiple management functions. An owner-employee often will have ultimate decision-making authority and responsibility on a wide range of management issues, such as personnel, capital budgeting, marketing, financing, price setting, quality assurance, and customer relations. In contrast, a non-owner employee is likely to have responsibility in only one of those critical management functions.

Well constructed salary surveys attempt to define specific job functions, so it is difficult to compare the compensation of an individual performing many functions with averages of individuals performing just one. A seemingly straightforward approach to this problem has been proposed by Marshall A. Morris in “Compensation Criteria for Business Valuations” (The Value Examiner, March/April 2006).

Morris suggests that if an owner-employee performs many management functions, the percentage of time spent on each task should be applied to average compensation paid for the appropriate job functions found in compensation databases. From these component averages, a blended compensation figure can be derived for substitution purposes.

In my opinion, the problem with Morris’s approach is that it only establishes a reasonable floor for the cost of substituting an owner-employee with a non-owner employee. In most circumstances, an individual’s willingness to assume multiple job functions would be accompanied by a demand for additional compensation beyond the amount received by employees performing only one function. Therefore, in calculating the true cost of substitution, some increment above the compensation derived using Morris’ approach is needed. This additional increment of compensation is a component of the responsibility premium described above.

**Economies of Scale and Specialization**

In small business operations, the presence of an owner-manager is vital to the survival of the business. In larger-scale operations, however, the ability to acquire internal and external audit functions and hire highly skilled and specialized management staff greatly mitigates (but never completely eliminates) agency problems. So the degree to which owner-managers can be replaced by non-owner managers is related to the scale of the operation.

Scale of operation is an important issue to which valuation theory has not given sufficient attention. The hypothetical sale of a small, closely held company may result in two different outcomes: Either the target company will remain small or the target company will be merged into a larger firm. In the former case, the new owner will have to maintain active engagement in the business. When a small closely held company is acquired by a mid-sized or large company, on the other hand, the owner-manager may in fact be replaceable.

But the question in a merger is not simply a case of substituting an owner-manager with one employee, but with several employees. The substitution likely will be fractional. The larger buyer probably already engages a number of skilled and specialized employees who can undertake the functions previously performed by the owner-manager. Therefore, Morris’s approach seems to apply in such cases, but the issue is far more complex than he suggests.

While it may be the case that a current owner-manager of a target firm spends roughly a third of his or her time on marketing, it cannot be assumed that a larger firm will allocate a third of its marketing manager’s time to the newly acquired operation. Economies of scale, presence of excess capacity, and other unique factors may indicate an allocation of some fraction less than one-third of his or her time to the acquired business. Similar issues of synergy will exist relative to all key management functions. Because of these synergies an owner-manager’s functions cannot be simply fractionalized and multiplied by average salaries found in databases to derive a meaningful substitution figure.

**Owner-Employee Databases**

The burdens of active owner participation in small businesses are significantly greater than the burdens faced by non-owner employees. People generally do not assume additional workplace burdens without additional compensation. Therefore, databases reflecting compensation paid to non-owner employees will not provide a direct way to measure the compensation that should be paid to owner-employees. The job functions of the two classes of employees simply are not directly comparable.

We should, therefore, restrict our attention to databases that include compensation paid only to owner-employees, in determining a responsibility premium.

The database we seek must provide a reasonable basis for allocating total owner income between wages and profit. The wage component should reflect compensation for duties of the sort assumable by a non-owner employee plus the premium for assuming responsibilities not delegable to non-owners. Can any currently available database provide such a reasonable basis of allocation? Can any database allow an isolation of the responsibility premium? Unfortunately not. To see why, let’s consider a widely used database, The *Almanac of Business and Industrial Financial Ratios.*

**Corporate Tax Return-Derived Data**

The *Almanac* database is developed from a stratified sample of corporate income tax returns. Data are derived only from corporate tax returns. Sampled data include publicly traded and closely held corporations. The *Almanac* includes a line item for officer compensation. This database clearly includes the salaries of both owner and non-owner managers. Unfortunately the database does not provide separate statistics for each of these categories. There are at

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2 The *Almanac* does break down company data by asset size. It is fairly safe to assume that compensation of owner-managers is better represented in companies at the lower range of size, rather than the upper range. However, even if we assumed that officer compensation reported in the smaller-size companies represented exclusively owner-manager compensation, the other problems I describe here mitigate the usefulness of the data in defining a “responsibility premium.”
least three other major problems with utilizing this database (or similar databases) to allocate income between wages and profit. These problems involve coverage, measurement bias, and the insufficiency of relevant data.

**Coverage Problems**

The *Almanac* fails to include information about non incorporated businesses, yet a very large percentage of small closely held businesses are either unincorporated or incorporated as limited liability companies. One reason for this omission is that under generally accepted accounting principles (GAAP), payments made to owners of unincorporated firms are *never* classified as wages. Such payments are always recorded as owner or partner draws in the equity section of the balance sheet, despite the fact that cash withdrawals are often in economic substance payments for services the owner renders to the business. In effect, all net income available to owners of these types of businesses is classified as profit.

In ambiguous cases where owners contribute both significant services and equity, allocations between wages and profit are neither required nor allowed. This failure to require allocations, no doubt, reflects a sage awareness of how difficult it would be to do otherwise. After all, GAAP is not shy about requiring salary allocations in other contexts. For example, in determining product and period costs, compensation expenses must be allocated according to job function or the way in which an employee splits his or her time among many job functions.

Clery, a database that includes only unincorporated businesses will not be able to provide information on owner employee compensation. The Almanac's decision to include only corporations makes sense precisely because these are the only businesses that even attempt to allocate owner-employee income between wages and profit. But this is a two-edged sword, because a large proportion of closely held businesses are unincorporated. A database such as the *Almanac* that excludes these businesses runs the risk of not representing the universe of closely held businesses.

**Measurement Biases**

Owner compensation reported in the *Almanac* almost certainly involves measurement biases caused by tax incentives to classify cash distributions as either wages or profits. The tax code contains incentives to under-report owner compensation for S corporation filers because S dividend distributions are not subject to payroll taxes. In the opposite direction, the code encourages over-reporting owner compensation for C corporations, because classifying profits as wages reduces double taxation.

Ideally, a database combining both types of corporate tax returns would result in the countervailing biases canceling each other. The under-reported S corporation owner wages combined with the over-reported C corporation wages should yield a "true" picture of owner compensation. Unfortunately, we have no way of knowing if indeed these biases cancel each other. It is very likely that in particular industries there are far more S corporation than C corporation returns, so the biases may not, in fact, cancel.

**Fuzziness of Allocations**

In every corporate business in which an owner-employee actively participates, someone decides how to allocate available income between wages and profits. The *Almanac*'s average amounts of officer compensation reflect the results of these allocation decisions. As valuation analysts we should consider the following questions:

1. Were these informed decisions?
2. Were the duties of the owner employee carefully analyzed?
3. Were compensation studies consulted?
4. Was there a thoughtful attempt to isolate and measure the responsibility premium? Or were the tax consequences of the allocation decision the primary consideration?

We cannot be certain of the answers to these questions, but a well informed response to them might be formulated this way: For small closely held businesses (the sort of businesses in which we are most interested), the answers to the first three questions are almost certainly no, and the answer to the question about tax consequences is certainly yes. In other words, the income allocation decision was not the result of careful analysis and comparison, but was based on the most desirable tax effects. This being the case, we

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4 The table at right shows the breakdown of the IRS filing statistics on its website for 2002 (the most recent year in which the number of filings for all categories of return is available):

<table>
<thead>
<tr>
<th>IRS Form</th>
<th>Number</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>1120</td>
<td>1,906,968</td>
<td>7.2</td>
</tr>
<tr>
<td>1120A</td>
<td>176,892</td>
<td>0.7</td>
</tr>
<tr>
<td>1120S</td>
<td>3,154,377</td>
<td>11.9</td>
</tr>
<tr>
<td>1065</td>
<td>2,242,169</td>
<td>8.5</td>
</tr>
<tr>
<td>Sched. C</td>
<td>18,405,923</td>
<td>71.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>26,405,923</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

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*Continued on Page 28...*
should abandon the Almanac (and similar databases) as a potential source of data about the amount of the responsibility premium.  

Can We Develop a Better Database?

Perhaps if we had a large enough budget, we could develop a useful database specifically designed to identify the extent of the responsibility premium. In our survey we might ask owners to classify the amount of available income between wages and profit and instruct them not to worry about income tax consequences. We might ask them to carefully consider the range of responsibilities they assume and pick a fair wage for assuming these burdens. We could help the owners select a fair wage by providing information on benchmark wages paid to non-owner employees for assuming similar (but lesser) management duties. Undoubtedly the owners would say the wage amount for an owner should be more than a non-owner manager receives. If the owner-employees were strongly motivated to provide a specific dollar figure, they might ask whether any benchmark surveys of owner employees exist that indicate what other owner-employees earned for assuming the full level of responsibilities that they assume.

To answer such a question honestly, we would have to admit that there is no such survey and that the point of doing the current survey is to establish a benchmark. But then how would well motivated owner-managers respond? Perhaps they would throw out percentages of what non-owner managers earn, or they would simply state that there is a specific dollar figure that they must earn in order to undertake the responsibility of running the business.

Would the answers provided by owner-managers be useful? Perhaps. However, I suspect that most owner employees do not particularly care how income is classified, as long as they believe their total income provides sufficient reward for their additional burdens. The precise parsing of total income between wages and profit may be of great concern to the IRS and to valuation analysts attempting to apply income method of valuation, but is of no particular importance to owner managers. Even with more elaborate surveying, therefore, we are not likely to get the well informed or useful answers we seek.

Determining Hours Worked

One aspect of the additional responsibility assumed by many owner managers is reflected in the likelihood that owner-managers work more hours than non-owner managers. To apply the substitution method, the dollars paid must be related to the number of hours worked by owner-managers. It would not be reasonable to apply a substitution wage based on a non-owner manager working 2,000 hours a year to an owner-manager who works 2,500 hours per year. In developing his methodology, Morris explicitly recognizes that many owner-executives probably work more hours than non-owner executives. To address this issue he provides a hypothetical example where he assumes that the owner-executive works 150 percent of the hours that non-owner executives work. It is important to emphasize that this is an assumption. As I point out below, making a similar assumption may be the only way to derive a measure of the responsibility premium.

Morris also correctly points out that most salary surveys do not provide information on total hours worked. While most salary surveys of non-owner managers currently do not supply this information, I believe they easily could. On the other hand, the logistical difficulties in attempting to assess the hours worked for owner-managers represent a far more daunting challenge in developing a database for comparative purposes.

First among these difficulties is the fact that the number of hours currently worked by owner-managers is not easily obtainable from financial or other records, nor is it necessarily documented anywhere. Any survey of owner-managers would in many cases have to rely on recall estimates of hours worked that may be unreliable.

Secondly, an owner’s current work hours may not be the best or only gauge of compensation comparability. The historical pattern of hours worked may be relevant in comparing owner and non-owner compensation. In the formative years of a business, an owner-manager may work a very large number of hours for meager pay. As the business matures and prospers, the number of owner hours needed may decline and the available compensation increase. Current compensation in these cases must not be compared simply to current work hours, but to past work hours as well. Past periods’ work hours will be even harder to ascertain than current work hours.

A third problem in measuring hours worked involves accounting for family contributions beyond those of the nominal owner. Many small businesses are literally family businesses. Often entire families are pressed into service. In many of these cases, family members other than the nominal

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*I want to emphasize two other points in regard to the Almanac. First, I believe that this database contains much useful and reliable information of great utility in the valuation process, even though it does not isolate an amount for the responsibility premium. Second, the Almanac is not unique in this regard; I do not believe that any other database provides sufficient information on this variable.
owner are not compensated directly or adequately. This may occur in husband-and-wife partnerships with income reported on a tax return as if only one spouse were performing services. For example, a Schedule C net income of $200,000 reported in only one spouse’s name may seem relatively high for an individual owner, but when the “unreported” hours of the spouse are factored in, the overall compensation appears to be more comparable to a single non-owner manager. The Social Security payroll tax rules provide an incentive to allocate the compensation of a married couple to only one spouse.

Finally, I believe that comparing the number of hours worked between owner and non-owner managers is not sufficient in itself to quantify the responsibility premium. This is due to the fact that for a non-owner manager there is an element of choice as to if and when extra hours are worked. In contrast, an owner-manager’s over time hours quite often cannot be planned for and there is nothing voluntary about the overtime hours. If the owner does not put in the extra work, the business fails.

An Arbitrary Solution?
Because no current database can reveal the extent of the premium demanded by owners to assume the responsibilities of running a closely held small business, the solution may be to apply an arbitrary percentage to the substitution value computed utilizing non-owner employee information. We could, by analogy to the wage and hour laws, apply a “time-and-a-half standard.” This would amount to a 50 percent premium. Table 1 shows an example applied to the case of Paula Hubbard in a typical year.

Skilled carpentry could be replaceable without a responsibility premium. Assume that the prevailing wage for such carpentry is $30 per hour. The full-time equivalent wage would be $33,000 ($30 x 1,100). Assume the average managerial wage levels are found in appropriate databases for non-owner employees, as shown in Table 2.

The time-and-a-half approach shown in Table 2 may appear identical to the method offered by Morris, but it is not. In his example on the application of his approach, Morris assumes that the hypothetical owner manager works 150 percent of the hours that the comparable non-owner manager works. However, he does not advocate generalizing this approach. In contrast, the method I suggest here admits frankly that, as a rule, we have no way to precisely compare the wages of non-owner and owner managers. All we know with certainty is that owners of small, closely held businesses assume greater responsibilities than non-owner managers, and that over extended periods owner-managers will demand and deserve greater remuneration for assuming these responsibilities. The logic is simple: Applying an arbitrary greater-than-one multiplier to the blended wages of non-owner managers better reflects the economics of small, closely held businesses than not applying such a multiplier. An arbitrary positive premium is deemed preferable to no premium.

The obvious problem with this approach is that we have no way of knowing whether the arbitrary time-and-a-half multiplier reflects the correct level of premium owner-managers demand in order to bear the responsibility of actively managing a small, closely held business. Thus it may be difficult for the valuation profession as a group to agree on a specific arbitrary responsibility multiplier.

A second and not insignificant problem involves the loss of credibility that may be involved in using an arbitrary approach to a critical valuation determination. The courts and others who rely on valuation expertise may expect that if parsing the income available to owners between free cash flow and compensation is so critical to the valuation process, then the profession ought to develop reliable databases to accomplish this with reasonable precision. We have not as a profession done so yet. Unfortunately, we may never be able to do so.

Table 1: Hubbard’s Cupboards Owner-employee Information

<table>
<thead>
<tr>
<th>Job Function</th>
<th>Annual Hours</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Carpentry</td>
<td>1,100</td>
<td>46</td>
</tr>
<tr>
<td>Personnel</td>
<td>600</td>
<td>25</td>
</tr>
<tr>
<td>Financial &amp; Accounting</td>
<td>600</td>
<td>25</td>
</tr>
<tr>
<td>Marketing</td>
<td>100</td>
<td>4</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>2,400</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Table 2: Paula Hubbard’s Substitution Wage

<table>
<thead>
<tr>
<th>Job Function</th>
<th>Average Annual Non-owner Wage</th>
<th>Percent</th>
<th>Allocated Wage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personel</td>
<td>$50,000</td>
<td>0.25</td>
<td>$12,500</td>
</tr>
<tr>
<td>Finance &amp; Accounting</td>
<td>65,000</td>
<td>0.25</td>
<td>16,250</td>
</tr>
<tr>
<td>Marketing</td>
<td>45,000</td>
<td>0.04</td>
<td>1,800</td>
</tr>
<tr>
<td><strong>Substitution Floor</strong></td>
<td><strong>120,000</strong></td>
<td><strong>0.54</strong></td>
<td><strong>30,550</strong></td>
</tr>
<tr>
<td>Responsibility Premium</td>
<td></td>
<td></td>
<td>1.5%</td>
</tr>
<tr>
<td><strong>Full Substitution Cost</strong></td>
<td><strong>121,550</strong></td>
<td><strong>0.55</strong></td>
<td><strong>32,000</strong></td>
</tr>
<tr>
<td>Carpenter Wage</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Wage Allocation</strong></td>
<td><strong>121,550</strong></td>
<td><strong>0.55</strong></td>
<td><strong>32,000</strong></td>
</tr>
</tbody>
</table>
Compensation vs. Free Cash Flow

In summary, the valuation profession has three obvious, yet equally unpleasant, choices in dealing with the issue of the responsibility premium. First it can pretend it does not exist, or that it is so small that in most cases it can be ignored. Second, it can adopt an arbitrary multiplier approach as outlined above. Third, it can invest, or get some other institutions to invest, a very large sum of money to develop a database specifically aimed at determining the amount of the premium. For all the reasons stated above, none of these are particularly appealing solutions.

There is a fourth, less obvious option that many, if not most, valuation theorists may be loathe to accept. This option would involve the abandonment of income methods of valuation in cases where the closely held business is so small that it requires the ongoing full-time involvement of an owner-manager. The logic here is simply that if you cannot with some precision distinguish free cash flow from reasonable owner compensation, you cannot accurately value the equity of the business using an income method. This is not necessarily a devastating result, as there are other methods of valuation that can be applied in such circumstances. I have argued elsewhere that in the case of small, closely held firms, equity value is often generated by owner compensation rather than free cash flow, and alternative appropriate valuation techniques can and should be applied in these cases. This fourth option is the one that I recommend.

Michael Sack Elmaleh, MS, CPA, CVA, holds an MS degree in accounting, and has served as a principal and partner in CPA firms in Madison, WI, for nearly 20 years. He has been retained as an expert witness in valuation cases in Wisconsin and Maryland. He has served as a past chair of the Wisconsin Institute of Certified Public Accountants Federal Taxation Committee. As an adjunct instructor in colleges in Maryland and Wisconsin, Elmaleh has taught mathematics, statistics, economics, corporate finance, and accounting. He has written several articles for The Value Examiner and is the author of Financial Accounting: A Mercifully Brief Introduction (Epiphany, 2006; paperback, 144 pages, $9.99). He maintains an accounting education website: www.understand-accounting.net. (e-Mail: msdodger@aol.com).

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