2023, Volume 7, Issue 2

ARM E-Journal™

ASA
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OFFICIAL PUBLICATION

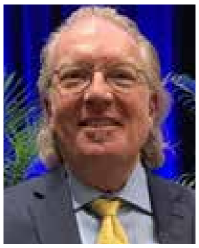
ASA Appraisal Review & Management Discipline

FEATURED ARTICLES

Federally Related Transactions Primer for Non-Real Estate Appraisers

Inside this Issue

Spotlighting Reviews of No-Standard Reports and Business Valuations



This month we have articles from a broad range of ASA members. Key topics this month are reviewing no-standard reports, and reviewing for business valuations.

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Jack Young

Jack Young, ASA, ARM
ARM Publication Chair and ARM E-Journal™ Editor
ASA 2021-2022 Appraiser of the Year

ARM E-Journal™

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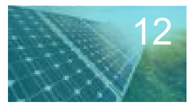

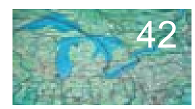

COLUMNS

Exciting ARM Updates!

Spotlighting Recent Successes and New Developments

I hope you all are doing well, staying safe, getting some sunshine, and enjoying the season. The Board of Governors (BoG) passed a resolution to reduce the number of Discipline Governors to one per discipline—while adding a new position for ARM Governor—while also decreasing the number of Regional Governors from 5 to 4, with the regional areas being redistributed. The reduction of governors will be staggered: all current governors will serve out their terms and will not be able to seek re-election. Jack Young was elected as the 2023-2024 ARM Governor. Richard Conti, ASA, ARM, and Charles Dixon, ASA, ARM, were also elected as ARM Discipline Committee Members-At-Large for a three (3) year term.

Melanie Modica recently concluded teaching the ARM 203 class with 7 attendees. Woohoo!

Our International Conference coming up in New Orleans this October 1-3 has a great line up and I look forward to those sessions and seeing those of you that will be there.

Let's Promote Careers in Appraisal
At our most recent Discipline Chair meeting a big topic is getting the younger generations into the practice. I am asking each of you to reach out to local college or university business departments and offer to be a speaker on the topic of appraising as a career choice. It's a career that's easy to overlook. Growing up, even though my dad was an appraiser (Richard Kaufman, FASA, Past American Society of Appraisers International President 1994-95), I never thought of going into the business. But in 2006, when he invited me to work with him on my first appraisal project, I realized the appeal. Now I can't imagine any other career would be more fulfilling. I have never been busier, and even companies that I sub-contract too are saying they've had a 60% increase over last year.

Artificial Intelligence Appraisal Platform
Lastly, I found out that Kroll has implemented an artificial intelligence appraisal platform, the Commercial Property Valuation Platform. I'll investigate it and provide an update at on the next Journal.

If I can be of any help, please reach out to me!

Matt Kaufman

Matt Kaufman, ASA, ARM
ARM Discipline Chair

Meet Your ARM Committee

1. Matt Kaufman, ASA, ARM
Chair

2. Terri Lastovka, ASA, ARM
Vice Chair
ARM Publication Reviewer

3. Melanie Modica, ASA, ARM
Secretary/Treasurer
ARM Education Subcommittee Chair
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4. J. Mark Penny, FASA, IA, ARM
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5. Barry J. Shea, ASA, ARM, IFA
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Deputy Chair, IES Coalition
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6. Cameron R. Tipton, ASA, ARM
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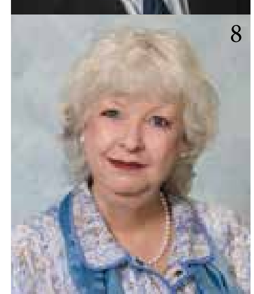
ASA Conference Committee
2022 ASA Rising Star

7. Faisel Hoodbhoy, ASA, ARM
Member at Large

8. Pamela Bensoussan, ASA, ARM
Member at Large
2019 Chapter Member of the Year
ARM Publication Reviewer

9. Raymond Rath, FASA, CEIV, IA, ARM
Member at Large
ARM Publication Reviewer



Open ARMs

ASA has Open ARMs for a Multitude of Learning Opportunities!

Second Debut Proves Very Successful

The AR203 course, Managing Multifaceted Assignments, was offered to members and prospective members in March 2023. Seven professionals from PP, MTS, BV, and RP learned together and shared a multitude of experiences that paired perfectly with the appraisal management methodology. The course includes two immersive and extensive—yet enjoyable and interesting— mock management assignments. Participants venture into educational mock managing of appraisers in their own disciplines, and then again by venturing into other disciplines. Both assignments include "hiring" colleagues, and all of the preparation work included. When working with colleagues who are already in established professional relationships, as well as newly formed ones, participants learn beyond the manual from extensive content in collaborations and discussions.

Managing a team of appraisers while acting as an appraiser, or only managing while not appraising, proves to be a different, yet healthy, challenge for new appraisal managers. Issues arise from collaborating on scopes of work, property division, inspections, oversight, and even quality control for accuracy and compliance. This second debut was structured and scheduled as three full days offered one Tuesday per week, during a three week span. This 'once a week' plan provides participants with the time to manage a mock team, discuss mock assignments, and prepare presentations to share with class colleagues.

Consider registering for the next AR203 and perhaps you'll reply with similar survey comments as these…

> *"I highly recommend this class. It covers everything you didn't know, but thought you did, on how to be an appraisal manager."*

> *"Loved the interaction and break-out sessions. The discussion gave a "real world" perspective, as opposed to textbook learning."*

> *"Discussion on practicality of applying appraisal management and divergent view points was most useful."*

> *"There is much to think through that is not immediately obvious in managing a multi-disciplinary engagement. This course forces us to perform that analysis."*

> *"Much more engaging to have frequent breakout rooms, guest speakers, and mock assignments that required us to interact with colleagues."*

> *"The tasks involving interviewing colleagues was great."*

"Appraisal management is much more complicated than I initially thought, and this course brought that to light and suggest how to address these complications."

"I've been making it up as I go along, This course work codifies it, and I like that idea."

Ready to advance and make that ARM accreditation a reality?

The AR204 Application & Report Writing course was offered to members and prospective members in April 2023. This class is the second requirement for adding the ARM accreditation to an existing accreditation of another discipline. AR201 and AR204 are the requirements for the "add on" ARM accreditation path. Detailed content for successfully producing an appraisal report is provided in an energetic, captivating, fast paced class. Participants end with an appraisal review report that is effectively organized, professionally structured, and ready to polish! Are YOU ready for your NEW ARM?

Need an Appraisal Review Report Writing REFRESHER So You Can Accredit?

The AR209 Appraisal Review Report Writing Workshop is a one day tutorial that can be offered ANY TIME when enough participants are ready to take the class. In fact…. all ARM Principles of Valuation courses will be scheduled when members and prospective members are ready to meet! Organize a group and ASA will host an ARM class for you!

Have a webinar idea for an Appraisal Review & Management audience?

Calling all presenters….Contact Ron Prat at ronprat@silverpilencorp.com or Melanie Modica at melanie@modicafineart.com.

Melanie Modica

Melanie Modica, ASA, ARM
ARM Education Subcommittee Chair

Welcome Our Latest ASA ARM Members

Joel Goldsmith, ASA, ARM

Joel is Director of Appraisal Operations for B Riley Advisory Services (fka Great American Group) and has over 30 years of experience in the appraisal profession, having served in the employ of leading appraisal firms and industrial auctioneers. His experience ranges over almost every category of M&E, mostly for lending purposes. Joel enjoys music of many genres, playing guitar and jamming with his five boys, who are all musicians.

Connect with Joel today!

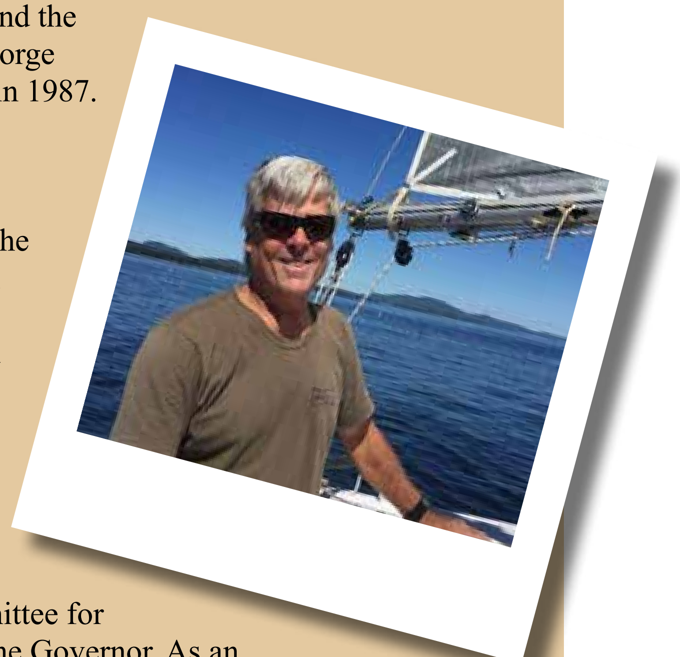
John Yeo, ASA, ARM

John is a Real Estate Appraisal Advisor working for the Canada Revenue Agency (CRA) in their Vancouver, British Columbia office. He is also an accredited member of the Appraisal Institute of Canada. He appraises primarily real estate but also completes appraisals on personal property, machinery & equipment that are subject to income taxation. He has completed the MTS program of study in 2018 along with four other CRA colleagues. John enjoys playing the piano and collecting old vinyl records in the popular music/light classical genres. He is trying to find time to listen to them all. He is married to Katherine. They have two sons, Nathan and Sean.

Connect with John today!

Charles C. Dixon, ASA, ARM

Charlie is president and owner of CD Valuation Services, Inc., which he started in 1994. In the early days, Charlie loved the New Jersey shore, surfing, and working as a short order cook. Later, his interest in cars and motorcycles inspired him to a career in the early 80s as a marine diesel mechanic working on tugboats and barges. Eventually tiring of the tough winters on the water, he became interested in the appraisal industry; appraising machinery and equipment seemed to fit with the mechanical background ... and the rest is history. His appraisal career started with George Sinclair, ASA, MAI, and Keystone Appraisal Co. in 1987.



An ASA member for over 30 years, Charlie is an ASA Accredited Senior Appraiser in the MTS and ARM disciplines, a Certified Senior Appraiser of the Equipment Appraisers of North America (EANA), and an Appraisal Qualifications Board (AQB) Certified USPAP Instructor (personal property). In addition to teaching USPAP, Charlie is an ASA instructor for POV courses and has presented a number of seminars on report writing, appraisal best practices, and other issues.

Charlie has served ASA internationally on the Machinery & Technical Specialties (MTS) Committee for over ten years and for two years as MTS Discipline Governor. As an active member of the Philadelphia ASA chapter, he served as Chapter President and was awarded the George D. Sinclair Award for Professionalism. Charlie currently serves ASA on the Educational Foundation, the Board of Examiners (ARM), and as co-editor of the ARM e-journal. He is also the Appraisal Review Chairman for the EANA.

Charlie and Nancy, his wife of 41 years, have three grown children, all married and with children of their own. Charlie still enjoys the shore and spending time with his family there, as well as cooking, wine, sailing, camping, and fly fishing.

Connect with Charlie today!

Continued Steps to Improve Governance

New Phased Restructuring of the Board of Governors to Take Place

ASA's Board of Governors (BoG) over the past four years has taken deliberate and continued steps to improve governance. The primary driver behind this effort is to better position the Society for long-term strategic success. Key actions taken to date have included: the implementation of a new governance model; modernization of related policy documents; new BoG monitoring procedures; increased transparency and communication to members; and implementation of a new strategic plan focusing on three pillars: Education, Membership and Branding.

A new and recent addition to this effort included a phased restructuring of the BoG to reduce the number of discipline governors from two to one and the addition of a new ARM discipline governor. This action was taken per the recommendation of the Board Reduction Taskforce after a period of detailed study to improve governance efficiency. The process will take place over the next several years and conclude as each current term is completed.

As part of the movement forward, the BoG's role will focus on addressing long-term strategic issues and initiatives, while the CEO position will work to address all operational activities through the support of staff and the numerous member volunteers involved in the Society's Standing Committees. Regular and ongoing monitoring by the BoG of key areas will occur to ensure proper due diligence is being conducted.

Benefits to the Society and members have already been visible, including the successful pivot to virtual and OnDemand educational offerings; comprehensive overhaul of the Society's technology platform with new Association Management System (AMS), Learning Management System (LMS) and Financial Management System (FMS); new refreshed website with upgraded Find an Appraiser search tool and new online membership directory; new soon to be released ASAConnect member community platform; new membership programs for students and Ally members; new member marketing toolkit; new branding campaign to promote members; and much more.

Your membership matters and is important to us. Know with confidence that your elected member volunteer leaders are doing an excellent job at laying the foundation for future success.

Johnnie White

Johnnie White, MBA, CAE, CMP, CEO/EVP

ASA ARM TRAINING, CREDENTIALING AND MEMBERSHIP

Better Manage Client's Risk Through Appraisal Review

Nobody understands the value and risks of your client's assets better than ASA. Which is why more appraisers, assessors, CPAs, bankers, attorneys, departments of governments or other users of appraisal services are turning to ASA for appraisal review support. ASA offers three pathways to mastering this critical differentiator. From a comprehensive credentialing or specialty designation program for practitioners to a certificate of completion program for allied professionals, ASA offers the advanced ARM training, credentialing and membership opportunities you need now!

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For more information visit www.appraisers.org/ARM, or contact asainfo@appraisers.org or (800) 272-8258.

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Federally Related Transactions Primer for Non-Real Estate Appraiser

By Gregory Patterson, ASA, ARM

Abstract: An introduction to Federally Related Transactions for multi-disciplinary appraisers working with lending professionals. An accompanying White Paper on the Federal Banking Agencies' Arbitrary and Capricious Efforts to Exempt the Vast Majority of Federal Real Estate Related Financial Transactions from Title XI of FIRREA's Appraisal Reforms proceeds article on ARM E-Journal pages 19-33.

What's an FRT?

A perplexing project crossed my desk recently. The call came on the Monday before Thanksgiving from a lender requesting an appraisal by the end of the year on a renewable energy startup company. I had worked with this lender on on several similar projects over the past few years to meet the reporting requirements for projects backed by the U.S. Department of Agriculture's Renewable Energy for America Program (REAP). Given the accelerated timeline over several holiday breaks, I sent the established service agreement template to get things moving.

Another call came from the lender shortly thereafter. REAP was not involved in the project, nor was any of the other federal or state loan guarantee programs. In fact, the $50 million project was fully guaranteed by the primary customer, one of the Top 100 of Fortune's largest private companies whose credit worthiness was not in question. Potentially regretting the answer, I questioned why an independent appraisal was required. Essentially, the reply was that they were not entirely sure, but wanted to cover their due diligence requirements since the project could be construed as an FRT by regulators.

The first question that came to mind was why a large regional bank experienced in these projects is not certain of regulatory requirements. The second question was, "What's an FRT?"

While our real estate brethren are certainly rolling their eyes now, this was the first time in 25+ years of appraisal practice that FRT or Federally Regulated Transaction had entered my vernacular. A quick online query and another to my real estate contacts returned similar answers and raised the same question: Because FRTs are only for real estate specialists, why would anyone need a business valuation appraisal?

Background

Federally Related Transactions (FRT) date back to the Financial Institution Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This federal legislation was enacted in response to the Savings and Loan Crisis of the 1980s and was one of the more significant attempts to restructure the rules and regulations of the U.S. lending system since the Glass-Steagall Act (part of the Banking Act of 1933).

Commonly known at the time as the *Savings and Loan Bailout Bill*, the statute's purpose was to restore public confidence in the savings and loan industry. The headline changes included:

- Abolishing the Federal Savings & Loan Insurance Corporation by giving the Federal Deposit Insurance Corporation (FDIC) responsibility for insuring the deposits of thrift institutions
- Creating FDIC insurance funds covering

“Appraisers and lenders alike should consider the practical implications of having FRTs viewed within a stricter interpretation of the original act and provide for prudent considerations in the valuing of assets.”

thrifts (Savings Association Insurance Fund) and banks (Bank Insurance Fund)
- Abolishing the Federal Home Loan Bank Board and creating two new agencies to replace it, the Federal Housing Finance Board and the Office of Thrift Supervision
- Creating the Resolution Trust Corporation (RTC) as a temporary agency that was given the responsibility of managing and disposing of the assets of failed institutions (The RTC was dissolved in 1995)

Included in the legislation was Title XI – Real Estate Appraisal Reform Amendments, which established a real estate appraiser regulatory system involving federal and state regulatory agencies and The Appraisal Foundation. The legislation sets out when real estate appraisals are required and to ensure that they are performed adequately.

To determine when appraisals are required, Title XI created FRTs, which requires 1) any real estate-related financial transaction[1] engaged in, contracted for, or regulated by a federal financial institution regulatory agency and 2) requires the services of an appraiser.

The purpose of FRT regulations is further clarified in the Interagency Appraisal and Evaluation Guidelines[2] first published in 1994 and updated in 2010. The jointly issued guidelines *"address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions. Further, these Guidelines provide federally regulated institutions and examiners clarification on the Agencies' expectations for prudent appraisal and evaluation policies, procedures, and practices."*

Exemptions

Title XI granted the federal regulatory agencies the authority to identify types of real estate-related financial transactions that do not require appraisals. Since enactment, financial institutions and federal regulators have attempted to continually expand the scope of these exemptions, to the point of the ASA co-issuing a white paper opposing their efforts.[3] The consensus[4] among real estate appraisers is that the net impact of the exemptions results in only 8% to 12% of real estate loans classified as FRTs.

For these exemptions, the regulations permit the use of an evaluation in lieu of an appraisal. A lending institution may use a variety of analytical methods and technological tools for developing an evaluation, provided the valuation method is consistent with safe and sound banking practices. Evaluations have less stringent standards than appraisals and are not USPAP compliant.

Exemptions include:

1. **Appraisal Threshold**. Individual transactions with a $400,000[5] value or less. For a transaction secured by several

[1] Any transaction involving 1) The sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; 2) The refinancing of real property or interests in real property; and 3) The use of real property or interests in property as security for a loan or investment, including mortgage-backed securities [12 USA §3550(5)].

[2] Federal Financial Institutions Regulatory Agency includes a) The Board of Governors of the Federal Reserve System; b) the Federal Deposit Insurance Corporation; 3) The Office of the Comptroller of the Currency; 4) The Office of Thrift Supervision; and 5) The National Credit Union Administration.

[3] A White Paper on the Federal Banking Agencies' Arbitrary and Capricious Efforts to Exempt the Vast Majority of Federal Real Estate Related Financial Transactions from Title XI of FIRREA's Appraisal Reforms. June 13, 2016. https://bit.ly/42CtI1z

[4] I was unable to source primary data.

[5] Increased from $250,000 in January 2020.

individual properties that are not part of a tract development, the estimate of value of each individual property should determine whether an appraisal or evaluation would be required for that property.

Comment: BV appraisers should be aware of this in preparing reports for entities with multiple real estate holdings (if the appraisal may be used for lending purposes).

2. **Abundance of Caution.** If an institution takes a lien on real estate in an abundance of caution rather than necessary collateral. This exemption is intended to have limited application, especially for real estate loans secured by residential properties in which the real estate is the only form of collateral.

   For a business loan to qualify for the abundance of caution exemption, the extension of credit needs to be well supported by the borrower's cash flow or collateral other than real property.

   The credit analysis should verify and document the adequacy and reliability of repayment sources and conclude that knowledge of the market value of the real estate on which the lien will be taken as an abundance of caution is unnecessary in making the credit decision.

   Comment: BV appraisers should be aware of this rule, even for larger multi-million-dollar transactions where real estate comprises a small portion of the lending assets.

3. **Loans Not Secured by Real Estate**. An appraisal is unnecessary on a loan that is not secured by real estate, even if the proceeds of the loan are used to acquire or improve real property, as long as it has no direct effect on the decision to extend credit because the institution has no legal security interest in the real estate.

   Comment: In the introductory example, the ~$20 million loan proceeds are to be used for improvements to real estate leased from a third party; another indication that it is not an FRT.

4. **Liens for Purposes Other Than the Real Estate's Value**. Allows liens against real estate without obtaining an appraisal to protect legal rights to, or control over, other collateral if it is not necessary to extend credit.
5. **Real-Estate Secured Business Loans**. The appraisal threshold for businesses is $1.0 million if the primary source of repayment is operating cash flow and not dependent on the sale of, or rental income derived from, real estate.

   This exemption will not apply to transactions in which the lender has taken a security interest in real estate, but the primary source of repayment is provided by cash flow or sale of real estate in which the lender has no security interest. For example, a transaction in which a loan is secured by real estate for one project, in which the lender has taken a security interest, but will be repaid with the cash flow from real estate sales or rental income from other real estate projects, in which the lender does not have a security interest, would not qualify for the exemption.

   Businesses are defined as any corporation, general or limited partnership, business trust, joint venture, syndicate, sole proprietorship, or other business entity, as well as including entities engaged in agricultural loans secured by farmland, timberland, and ranchland committed to ongoing management and agricultural production.

Comment: BV appraisers should be aware of this rule when working on large, complex projects for lending purposes and whether a portion of the transaction can be classified as an FRT.

6. **Leases**. An institution is required to obtain appraisals of leases that are the economic equivalent of the purchase or sale of the leased real estate. For example, an institution must obtain an appraisal on a transaction involving a capital lease, as the real estate interest is of sufficient magnitude to be recognized as an asset of the lessee for accounting purposes. Operating leases that are not the economic equivalent of the purchase or sale of the leased property do not require appraisals.
7. **Renewals, Refinancings, and Other Subsequent Transactions**. Under certain circumstances, renewals, refinancings, and other subsequent transactions may be supported by evaluations rather than appraisals. Those include when there has been no obvious and material change in market conditions or physical aspects, or there is no advancement of new monies other than funds necessary to cover reasonable closing costs.
8. Transactions Involving Real Estate Notes. This applies to transactions involving the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities. If each note or real estate interest meets the regulatory requirements for appraisals at the time the real estate note was originated, a new appraisal is not needed.
9. T**ransactions Insured or Guaranteed by a U.S. Government Agency of U.S. Government-sponsored Agency.** Appraisals are not needed for transactions that are wholly or partially insured or guaranteed by a U.S. government agency or U.S. government-sponsored agency as it is expected these meet all underwriting requirements of the federal insurer or guarantor, including its appraisal requirements, in order to receive the insurance or guarantee.
10. **Transactions that Qualify for Sale to, or Meet the Appraisal Standards of, a U.S. Government Agency or U.S. Government-sponsored Agency**. This exemption applies to transactions that either qualify for sale to a U.S. government agency or U.S. government-sponsored agency, or (ii) involve a residential real estate transaction in which the appraisal conforms to Fannie Mae or Freddie Mac appraisal standards applicable to that category of real estate.
11. **Transactions by Regulated Institutions as Fiduciaries.** An institution acting as a fiduciary is not required to obtain appraisals under the appraisal regulations if an appraisal is not required under other laws governing fiduciary responsibilities in connection with a transaction.
12. **Appraisals Not Necessary to Protect Federal Financial and Public Policy Interest or the Safety and Soundness of Financial Institutions**. The respective agencies retain the authority to determine when an appraisal is not required to protect federal financial and public policy interests or the safety and soundness of financial institutions. This exemption is intended to apply to individual transactions on a case-by-case basis rather than broad categories of transactions that would otherwise be addressed by an appraisal exemption. An institution would need to seek a waiver from its supervisory federal agency before entering the transaction.

Other Considerations

An aspect of FIRREA that is gaining awareness is its use to law enforcement. Largely unused for two decades, the Department of Justice (DOJ) under President Obama and President Biden increased its focus on white collar enforcement actions against individuals and financial institutions. Although a civil statute, FIRREA was used to prosecute wrongdoing following the 2008 mortgage crisis; the DOJ secured billions in settlements following the subprime mortgage crisis and later for other white-collar prosecutions, including fraudulent PPP[6] loans to businesses.

FIRREA has several civil enforcement features making it a strong prosecution tool for the DOJ:

- The burden of proof is much lower for civil actions than criminal proceedings and provides significant investigative powers.
- The statute of limitations for FIRREA civil enforcement is 10 years, much longer than most civil statutes of limitations of three to five years.
- FIRREA statutory penalties are over $1 million per violation, or over $5 million for continuing violations that enables large settlements.
- FIRREA also allows courts to increase the penalties up to the amount of the pecuniary gain derived from the violation.
- In 2021, the DOJ recovered over $5.6 billion under FIRREA, up from $3 billion in 2019.

Conclusion

Statutory regulations regarding FRTs are strictly targeted at real estate-related transactions and real property appraisers. The number of actual FRTs is likely very low compared to the overall number of total real estate transactions. However, appraisers in other disciplines such as business valuation and appraisal review would be prudent to have a cursory understanding of FRTs before providing services to federally regulated lending institutions. The sources cited in this article provide for a solid understanding of issues surrounding FRTs, but they only scratch the surface and the information is disseminated.

Perhaps the most concerning aspect of FRTs may be the 10-year statute of limitations. A decade provides a long runway for revisionist history and FIRREA has a wide scale of opportunities for a new generation of regulators to reinterpret the statute, regulations, and enforcement opportunities. Appraisers and lenders alike should consider the practical implications of having FRTs viewed within a stricter interpretation of the original act and provide for prudent considerations in the valuing of assets.

I still do not have an answer to my original question of why the lender thought the transaction mighy constitute an FRT … but considering the current political, regulatory, and financial lending environment, my guess is an appraisal makes for relatively inexpensive insurance for the lender to illustrate they were following safe and sound practices in the event of a revisionist regulatory environment.

About the Author

Greg Patterson, ASA, ARM, has been in the business valuation and services industry for over 25 years. Based in Iowa, he serves clients from the Midwest as well as from the EU/UK to Alaska and Guam. Over the past years, Greg served each officer position in the Iowa/Nebraksa Chapter of the ASA twice. A graduate of the University of Iowa and Drake Law School, he has been at HDH Advisors since 2007.

[6] Paycheck Protection Program loans as part of the Coronavirus Aid, Relief and Economic Security (CARES) Act and subsequent legislation and programs.

Editor's Note: The following is an accompanying White Paper for the previous article: *Federally Related Transactions Primer for Non-Real Estate Appraiser* on ARM E-Journal pages 12-18.

American Society of Appraisers

Providing Value Worldwide

NATIONAL ASSOCIATION OF INDEPENDENT FEE APPRAISERS

A White Paper on the Federal Banking Agencies' Arbitrary and Capricious Efforts to Exempt the Vast Majority of Federal Real Estate Related Financial Transactions from Title XI of FIRREA's Appraisal Reforms

June 13, 2016

EXECUTIVE SUMMARY

The banking agencies, led by the FDIC, have recently taken the position that the vast majority of real estate related financial transactions in which the government has a safety and soundness or a consumer protection responsibility are exempt from Title XI.[1] They have made clear that under their restrictive interpretation of Title XI's "federally related transaction" phrase, the appraisal law does not apply to or protect the hundreds of billions of dollars in mortgage loans guaranteed by the FHA, the VA or USDA's rural housing program; the mortgages purchased and sold by Fannie Mae or Freddie Mac; and, any originated mortgage which even qualifies for sale to a GSE. This shocking interpretation of Title XI – which places the overwhelming majority of all residential mortgages beyond the law's protections – surfaced and became clear only recently when it was announced by a representative of the FDIC at an April 2016 meeting of state appraiser licensing agencies. As word of the FDIC's Title XI interpretation spread, it stunned federal agencies which have relied for many years on the law's provisions as well as its private sector stakeholders.

The FDIC (and, it seems, the other federal banking agencies) argue that they exempted these transactions in their 1994 Appraisal and Evaluation Guidelines by declaring that they are not "federally related transactions" within the meaning of the law. This position is indefensible and flat-out wrong. As explained in some detail below, the banking agencies' current interpretation of Title XI is directly contradicted by the following facts –

(1) **All Title XI stakeholders disagree:** All Title XI stakeholders at the state and federal levels of government and in the private sector have had a common understanding for 25 years that the law was intended to be broad-based and that it applied to all real estate related financial transactions. This

[1] Under Title XI, the term "real estate-related financial transaction" means "any transaction involving—
(A) the sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof;
(B) the refinancing of real property or interests in real property; and
(C) the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities."

common understanding existed prior and subsequent to issuance of the 1994 Appraisal Guidelines and continues to this day; (See page 7 for more detail)

(2) **The federal banking agencies have never objected, until now, to the broad interpretation of Title XI's reach that the state appraiser licensing agencies, the government's housing and mortgage insurance agencies and the federal Appraisal Subcommittee have observed for decades:** It is important to recognize that while the banking agencies now contend they exempted the vast majority of real estate related financial transactions from Title XI in 1994, they have known for dozens of years that the state licensing agencies and the federal Appraisal Subcommittee were exercising their Title XI responsibilities as applying broadly across government agencies and that the government's housing and mortgage guaranty/insurance agencies had depended on and had benefitted from Title XI's protections – yet the federal bank regulators never objected. They never once told these state and federal entities that their interpretation of the appraisal law was in conflict with their regulatory Guidelines and was, therefore, invalid. The banking agencies' "say nothing, do nothing" stance until now demonstrates that their current interpretation of "federally related transaction" is actually a reinterpretation of the law that is arbitrary and capricious;

(3) The legislative history of Title XI Is conclusive that Congress intended the law to apply broadly across all government housing and mortgage programs: The conditions which gave rise to Title XI as well as its legislative history clearly demonstrate that it was intended by Congress to apply broadly across all real estate related financial transactions involving governmental programs. Moreover, the principal author and the Congressional sponsors of Title XI were acutely aware of the banking agencies' regulatory failures in connection with the 1980s collapse of the thrift industry, including their inattention to the role played by an unregulated appraisal services industry and faulty and fraudulent appraisals which added billions of dollars to the cost of the S&L cleanup. Given this legislative history, it is inconceivable that Congress intended for these same regulatory agencies to have authority not only to rewrite the appraisal reform law but to effectively repeal it for most real estate related financial transactions, as they are attempting to do and close to doing; (See bottom of page 7 for more detail)

(4) **Subsequent to the 1994 Appraisal and Evaluation Guidelines, Congress enacted major laws that applied Title XI to federal programs that the banking agencies say they have exempted from the appraisal law:** Congress has recently enacted major laws which explicitly extend Title XI to federal housing and mortgage guaranty programs that the banking agencies say are exempt from Title XI because they are not federally related transactions. It is beyond improbable that Congress would enact laws which extended Title XI requirements to federal programs that the banking agencies' claim are not covered by Title XI if Congress didn't believe that these programs are, in fact, covered by the appraisal law. It is absurd to believe that the banking agencies have a better and more authoritative understanding of the intent of Congress when it enacted Title XI than Congress itself; (See page 11 for more detail)

(5) **The exemption provisions of the 1994 Appraisal Guidelines, which the banking agencies now claim excluded most transactions from Title XI requirements, do no such thing. A full reading of the Guidelines makes clear that at the time they were issued, the banking agencies did not exempt the government's real estate related financial transactions from Title XI's <u>enforcement</u> provisions:** The banking agencies' contention that its 1994 Appraisal and Evaluation Guidelines exempted most real estate related transactions from the entirety of Title XI is false. A complete reading of those Guidelines demonstrates clearly that it does no such thing. Apart from the fact that Title XI does not give the banking agencies any exemption authority, the most that can be argued is that the 1994 exemptions only apply to Title XI's appraiser qualifications and appraisal standards provisions (and only if the affected housing and mortgage agencies already had their own comparable appraisal requirements – which they did). The plain language of the 1994 Guidelines makes clear that the exemptions did <u>not</u> apply to Title XI's enforcement provisions (i.e., the state appraiser licensing agencies and the federal Appraisal Subcommittee) – provisions without which there is no realistic way to ensure compliance with the law's substantive requirements. They merely recognized that since these agencies had appraiser qualifications

and appraisal standards comparable to those of Title XI, requiring them to meet the Title XI provisions would be redundant. (See page 9 for more detail)

The points made in this Executive Summary are discussed below and in the pages that follow in more detail.

I. Background of the Banking Agencies' Aggressive Efforts To Restrict the Reach of Title XI

The federal bank regulatory agencies are on the verge of effectively repealing Title XI of FIRREA by taking the position that its appraisal reforms only apply to a tiny fraction of all real estate related financial transactions in which the federal government has a safety and soundness or a consumer protection responsibility. They have done so in two ways: First, by defining a key operative phrase in Title XI ("federally related transaction") in a way that dramatically shrinks the reach of the law; and Second, by approving a series of increases in the de minimus dollar threshold under which a Title XI professional appraisal of residential property is not required: from a $50,000 threshold in 1990 to $100,000 in 1992 and to $250,000 in 2010 (the current threshold). An additional threshold increase to $400,000 or $500,000 is currently being considered by the banking agencies under the EGRPRA regulatory review process.

The FDIC appears to be the lead agency in declaring that Title XI gives the banking agencies unprecedented legal authority to unilaterally dismantle, by administrative fiat, the law they are required to administer as Congress intended. A senior representative of the FDIC told an April meeting of Association of Appraiser Regulatory Officials (AARO) that under its interpretation of the Title XI phrase, "federally related transaction", only about 10% - 12% of all governmental real estate related financial transactions are covered by the law. The FDIC representative also said that if the additional de minimus increase being considered is adopted, the 10% to 12% number would fall to about 4% of all real estate related financial transactions.

Although the conference attendees were startled by the FDIC representative's message (i.e., that their decades old interpretation of what is or is not a federally related transaction was wrong), they were told that they shouldn't be surprised by the pronouncement because the banking agencies exempted most such transactions from the jurisdiction of Title XI twenty-two years ago in the 1994 Interagency Appraisal and Evaluation Guidelines (see appendix A, exemptions 9 and 10). However, as is made clear in this paper, none of the Title XI government agency or private sector stakeholders – none – understood exemptions 9 and 10 as having the meaning and effect the FDIC now says it does. Moreover a careful and common sense reading of the 1994 Guidelines leads to an interpretation of exemptions 9 and 10 that is very different than – and inconsistent with – the FDIC's current interpretation (also explained below).

II. The de minimus dollar threshold issue

While the focus of this White Paper is on the banking agencies' improper definition of the Title XI phrase, "federally related transaction", the agencies' systematic and arbitrary increases in the dollar threshold below which appraisals are not required (and the prospect of further increases) also severely undermines the effectiveness of Title XI and, we believe, deserves the intervention of Congress. While Title XI does grant the banking agencies authority to increase the dollar threshold if they determine that an increase will not impact the safety and soundness of financial institutions, it should be self-evident that Congress never intended that authority to be exercised in a way that effectively repeals a law whose central purpose affirms and promotes the role of appraisals as the most effective method to ensure the reliability and integrity of collateral valuations for loans ultimately backed by taxpayers. If the banking agencies believe that professional appraisals of properties collateralizing millions of residential mortgage loans that are guaranteed or insured by taxpayers, are an unnecessary component of safe and sound loan underwriting, then it should ask Congress to amend Title XI in a way which explicitly gives them limitless authority to eliminate or marginalize the role of appraisals in the underwriting process. They do not now have this authority.

Given the strongly pro-appraisal policies of the government's housing and mortgage guaranty agencies and given the collapse of the housing and mortgage markets in the 1980s and much more recently, we do not believe that Congress will share the apparent view of the bank regulators that appraisals are a throw-away part of loan underwriting and grant them such authority. Our view is that the current $250,000 threshold for residential loans represents an abuse of the discretion Congress granted the banking agencies and we respectfully urge Congress to address this matter at its earliest opportunity.

III. The "federally related transaction" Definition Crisis

The banking agencies have made clear that under their restrictive interpretation of Title XI's "federally related transaction" phrase, the appraisal law does not apply to or protect any FHA or VA housing loan guaranty; any USDA rural housing program; any Fannie Mae or Freddie Mac mortgage purchase or sale; and, any mortgage origination that simply qualifies for sale to a GSE. This shocking interpretation of Title XI – which places the overwhelming majority of all residential mortgages beyond the law's protections – surfaced and became clear only recently and stunned Title XI stakeholders, in both the public and private sectors.

The banking agencies' interpretation of the "federally related transaction" phrase, means that neither Title XI's substantive appraisal provisions (i.e., appraiser qualifications and adherence to the Uniform Standards of Professional Appraisal Practice or USPAP) nor the enforcement infrastructure it established (i.e., the state appraiser licensing boards and the federal Appraisal Subcommittee) are available to users of appraisal services or to federal agencies that administer programs dependent on reliable uniform appraisals and on professional appraisers whose work is overseen by the state licensing agencies which credentialed them. Without these state and federal enforcement mechanisms, there is no realistic or cost-effective way to ensure compliance by appraisers and by users of their services with Title XI's appraisal reform provisions or with the appraisal policies of government agencies.

The improbability of the legitimacy of the banking agencies' interpretation is clearly illustrated by the following bullet points:

- **The banking agencies' interpretation is contradicted by the fact that Title XI's stakeholders both in government and in the private sector have believed for 25 years that the appraisal reform law is extremely broad-based. In other words, they are in profound disagreement with the banking agencies' interpretation.**

Federal officials whose agencies administer the nation's housing and mortgage guaranty programs have for decades operated on the basis of their belief that Title XI applies to the programs they administer. Indeed, the appraisal regulations and written policies of agencies such as FHA, VA, USDA, FHFA and the GSEs are filled with references to and reflect a dependence on Title XI, including the enforcement mechanisms it established in the form of the state appraiser licensing agencies and the federal Appraisal Subcommittee. These agencies are responsible for ensuring that valuations for federal purposes are performed by state certified or licensed appraisers who are accountable to their state licensing boards for their professionalism. Without the backup of Title XI's enforcement provisions, <u>each</u> of these agencies and enterprises – which rely greatly on the services of state licensed and certified appraisers – would be required to establish their own qualifications requirements for individuals who wish to provide them with collateral valuation services; to establish testing protocols to ensure that applicants meet the qualifications requirements; and, to create their own enforcement and sanctions mechanisms – functions which if not available through the Title XI structure would cost taxpayers tens or hundreds of millions of dollars to create and administer themselves.

- **The banking agencies' interpretation of their powers to restrict the reach of Title XI is sharply contradicted by the legislative history of the law and by strong indicators of Congressional intent that it should operate broadly across government housing and mortgage market programs**

The banking agencies' actions are unambiguously contrary to the legislative history of Title XI and to Congressional intent. What Congress intended as a robust appraisal reform law designed to protect broad federal programs and interests, is close to becoming a nullity.

The agencies have falsely determined that Congress intended for Title XI's appraisal reform provisions to cover only an insignificant fraction of government housing and mortgage programs – a far-fetched and even preposterous assertion given that the law was an important component of Congress's aggressive overall legislative response to the banking agencies egregious regulatory failures relative to the collapse of the S&L industry in the 1980s. One of the most serious of those regulatory failures was the banking agencies lack of attention to the flood of poor quality appraisals that were used by lenders to make thousands of bad real estate loans appear to be adequately collateralized; and, to the billions of dollars in added losses to the federal deposit insurance system caused by an unregulated appraisal services industry and by faulty and fraudulent appraisals.

The enactment of Title XI was a direct result of and reflected information gathered at more than a dozen Congressional oversight hearings which broadly examined the role of faulty real estate appraisals on a wide range of federal interests. The subject matter of these hearings involved not just the collapse of the S&L industry and the billions of dollars in losses to the FSLIC resulting from faulty and fraudulent appraisals of collateral properties but also the negative effects of poor quality appraisals on the government's home loan guaranty programs (i.e., FHA and VA) and the mortgage purchase and secondary market activities of Fannie Mae and Freddie Mac. Many other federal agency programs which rely to some extent on real property valuations were also examined during the hearings, including rural housing and multi-family programs. The provisions of Title XI were intended by its sponsors and by Congress to apply broadly to all real estate related financial transactions where the reliability of property appraisals had always been important to the mission of the agencies administering them.

Given this history, it is beyond improbable that Congress intended Title XI's appraisal reforms to only apply to an insignificant slice of federally related transactions in situations where reliable valuations of collateral property are an important component of safe and sound mortgage loan underwriting. It is equally improbable that Congress would entrust the banking agencies with carte blanch authority to dismantle the law by administrative fiat.

Importantly, since its enactment in 1989 and notwithstanding the highly restrictive interpretation of the law by the banking agencies, all Title XI stakeholders, both in government and in the private sector, have regarded the law as applying to a broad range of real estate related financial transactions in which the government has a safety and soundness or a consumer protection responsibility. This includes the entire community of professional appraisers; all the state appraiser licensing agencies; the federal Appraisal Subcommittee; the real estate, mortgage and housing industries; <u>and, critically, Congress itself</u>. This commonly held belief continued after issuance of the 1994 Interagency Guidelines which purported to exempt most real estate related financial transactions from the law; and it continues to this day.

Nevertheless, the FDIC representative's assertion at the recent AARO meeting that 85 - 90 percent or more of real estate related financial transactions are exempt from Title XI has caused great consternation and confusion at the state appraiser licensing agencies and among other Title XI stakeholders. They were also told that this pronouncement should not come as a surprise because the banking agencies exempted these transactions in the Appraisal & Evaluation Guidelines they issued in 1994 – 22 years ago.

- **The banking agencies' current explanation of what was intended by exemptions 9 and 10 in the 1994 Appraisal and Evaluation Guidelines is inconsistent with – and contrary to – the full text of the Guidelines**

The FDIC's recent explanation of the purpose and effect of exemptions 9 and 10 is inconsistent with the full text of the 1994 Guidelines as well as the text of the current Guidelines which were issued on December 2, 2010. Section VII of these Guidelines entitled "Transactions That Require Appraisals" states: "Although the Agencies' appraisal regulations exempt certain real estate related financial transactions from the appraisal requirements, **<u>most</u> real estate related financial transactions over the appraisal threshold are considered federally related transactions and, thus, require appraisals.**" (Emphasis added).

This declaration stands in stark contrast to the FDIC's current position that most transactions are not federally related transactions.

As further evidence that the banking agencies' current interpretation of "federally related transaction" is actually a reinterpretation that is clearly erroneous, consider that the commentary accompanying the 1994 and the 2010 Guidelines relating to the exemptions makes clear that they only relate to Title XI's appraiser qualifications and appraisal standards requirements if the loan guaranty agencies and the secondary market enterprises already have comparable requirements – which they did. The exemptions in the Guidelines do not create an exemption from Title XI's enforcement provisions (i.e., the state licensing agencies and the federal Appraisal Subcommittee) and were never intended to do so. A reading of the plain language of the exemption provisions of the Guidelines makes this conclusion certain:

> **"9. Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government-Sponsored Agency**
>
> This exemption applies to transactions that are wholly or partially insured or guaranteed by a U.S. government agency or U.S. government-sponsored agency. The Agencies expect these transactions to meet all the underwriting requirements of the Federal insurer or guarantor, including its appraisal requirements, in order to receive the insurance or guarantee. (Emphasis added)
>
> **10. Transactions That Qualify for Sale to, or Meet the Appraisal Standards of, a U.S. Government Agency or U.S. Government-Sponsored Agency**
>
> This exemption applies to transactions that either (i) qualify for sale to a U.S. government agency or U.S. government-sponsored agency,[43] or (ii) involve a residential real estate transaction in which the appraisal conforms to Fannie Mae or Freddie Mac appraisal standards applicable to that category of real estate. An institution may engage in these transactions without obtaining a separate appraisal conforming to the Agencies' appraisal regulations. Given the risk to the institution that it may have to repurchase a loan that does not comply with the appraisal standards of the U.S. government agency or U.S. government-sponsored agency, the institution should have appropriate policies to confirm its compliance with the underwriting and appraisal standards of the U.S. government agency or U.S. government-sponsored agency." (Emphasis added)

It is unsurprising, therefore, that all the federal, state and private sector stakeholders understood that the so-called exemptions found in the 1994 Guidelines related only to the Title's appraiser qualifications and appraisal standards provisions based on the fact that these agencies' own appraisal requirements were comparable to those in Title XI. Applying Title XI's appraiser qualifications and appraisal standards provisions would have been redundant. None of the federal agencies believed or had reason to believe that the appraisers and appraisals utilized in connection with their programs were exempt from the enforcement authority of the state appraiser licensing agencies and the federal Appraisal Subcommittee. Nor did any of the private sector stakeholders involved in mortgage loans guaranteed or insured by government agencies or enterprises believe that the 1994 Guidelines exempted them or their transactions from the entirety of Title XI.

Title XI stakeholders understood that exemptions 9 and 10 in the Guidelines were nothing more than an acknowledgement that the FHA, VA, FHFA, USDA and the GSEs already had in place substantive appraiser qualifications and appraisal standards that were equivalent to, or strong than, those established in Title XI; and that applying Title XI's substantive requirements was unnecessary.

- **The banking agencies current interpretation of "federally related transaction" is directly contradicted by the enactment of laws subsequent to 1994 that extended Title XI to transactions the FDIC now says are outside the scope of Title XI because they are not federally related transactions**

Consider, for example, that in 2009, the Housing and Economic Recovery Act directed that "any appraiser chosen or approved to conduct" FHA appraisals must hold a state certified appraiser credential (previously, licensed appraisers were eligible to perform FHA-related valuations). It is extremely difficult to understand why Congress, in 2009, would legislate an improvement in FHA's appraisal requirements if Congress believed that 15 years earlier the banking agencies had exempted FHA's loan guaranty programs from the authority of the state licensing agencies established pursuant to Title XI to credential appraisers and oversee their professionalism; and exempted FHA's appraisers from the indirect authority of the federal Appraisal Subcommittee. Federal programs which rely on the services of state certified or licensed appraisers are tied into and depend upon Title XI (in some cases to establish appraiser qualifications and appraisal standards if the agencies don't already have them) but always in connection with the Title's enforcement mechanisms which ensure the integrity and uniformity of federally-related valuations.

Consider what <u>each</u> federal agency utilizing the services of certified and licensed appraisers would have to do if their programs were exempt from Title XI: Each agency would be forced to establish their own qualifications and standards requirements for their appraisers; each would be required to test and approve or deny eligibility to those wanting to perform appraisals for the government; each would be required to create teams of investigators to review complaints of appraiser incompetence or misconduct; and, each would have to establish their own sanctions regimes for alleged misconduct or negligence including due process protections. In short, each federal agency with a need for appraisal services would have to duplicate systems which are already in place pursuant to Title XI. This would cost taxpayers tens and possibly hundreds of millions of dollars.

Also consider that in 2010, Congress enacted Dodd-Frank which included numerous important changes to Title XI's appraiser certification and licensing system that directly impact appraisals performed for the government's principal housing and loan guaranty programs – programs which the FDIC now claims are not even subject to Title XI because they are not federally related transactions.

For example, Dodd-Frank's appraisal provisions strengthen Title XI's appraiser independence provisions by prohibiting acts and practices which seek to improperly influence an appraiser's opinion of value and by requiring that appraiser's be paid customary and reasonable fees. Dodd-Frank also amended Title XI by requiring state appraiser agencies to regulate Appraisal Management Companies (through which most appraisal engagements are ordered by mortgage lenders); by mandating that the federal Appraisal Subcommittee award grants to state licensing agencies so that they can more effectively investigate complaints filed against their appraisers; by establishing an appraisal complaint hotline to enhance the enforcement powers of state licensing agencies; and, by giving the Appraisal Subcommittee explicit authority to engage in rulemaking on issues central to the effective functioning of the system Title XI created.

If Members of Congress shared the FDIC's view that only about 10% of all real estate related financial transactions are federally related transactions covered by Title XI, they never would have devoted the time and effort necessary to enact such far-reaching Title XI changes.

Moreover, virtually all of the appraisal authority and requirements established by Congress in the Housing and Economic Recovery Act of 2009 and in the Dodd-Frank Act of 2010 would be a nullity if the FDIC's reinterpretation of Title XI were allowed to stand. Whose judgment should prevail on the issue of Congressional intent with respect to whether Title XI was intended to operate broadly across government programs or narrowly: Congress itself or the banking agencies? The question answers itself.

IV. Additional Points for Clarification Purposes

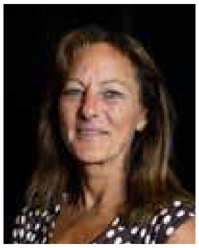
- Title XI was constructed in two interdependent ways to safeguard federal interests: First, it established substantive requirements to ensure appraiser competency, independence and accountability and mandated appraiser adherence to the uniform standards of professional appraisal practice (USPAP); and, second, it established an institutional framework to ensure and enforce compliance with appraiser qualifications and uniform appraisal standards. This institutional framework is composed of appraiser licensing agencies (in the 50 states, four territories and DC) which test and license professional appraisers and can sanction them based on a finding of negligence or unethical behavior; and, a federal Appraisal Subcommittee (which is a part of the Federal Financial Institutions Examination Council or FFIEC) to oversee the licensing agencies to ensure their diligence and effectiveness. Without this institutional framework, Title XI's substantive requirements would exist in a vacuum without the ability to be enforced;

- State laws establishing real estate appraiser licensing agencies pursuant to Title XI of FIRREA generally limit the authority of these agencies to "federally related transactions" performed within the state. As a result, transactions exempted from Title XI by the federal banking agencies are largely beyond the scope of the authority of most state appraiser licensing agencies and entirely beyond the scope of the authority of the federal Appraisal Subcommittee which oversees the effectiveness of the state appraiser licensing agencies. While states with laws that mandate the use of licensed or certified appraisers for all transactions within their state might be able to exercise some authority over exempted transactions, the extent of their authority over non-federally related transactions has never been tested. Moreover, if 85 – 90% of transactions occurring in a state are no longer considered federally related transactions by the banking agencies, the legislatures in these states would be tempted to amend their appraisal licensing laws to restrict the activities of their appraiser licensing agencies just to federally related transactions and pare their budgets accordingly. This is a likely scenario because the impetus to establish state appraiser licensing agencies in the first place resulted from the enactment of Title XI and the belief that the vast majority of real estate related financial transactions occurring in the states were federally related transactions. If most are now deemed not to be federally related transactions, many of these appraiser licensing agencies would be shut down or their activities substantially curtailed.

Review of the No-Standard Appraisal Report

By Terri Lastovka, ASA, ARM

Abstract: Appraisal review is often used to assess the creditability of an appraisal report. This article discusses how to use the factors of USPAP Rule 3-3 to develop and report an appraisal review assignment, particularly in litigation situations.



Reviewing for Credibility

Appraisal Review is frequently thought of as testing for compliance to USPAP or some other professional appraisal standard such as SSARS[1], NACVA[2], or IVS[3]. But when working in the litigation arena, we frequently find ourselves up against an expert report that is prepared by someone without any appraisal credentials; and therefore, no standards to be applied (or reviewed against). Now what?

An expert's role in court is to assist the trier of fact—that is the judge or magistrate. It is our job to assist the hearing officer as to the creditability of an appraisal report. So, what are we looking for?

Factors of CAARR:

The five factors of CAARR are the essence of USPAP Rule 3-3. A report that does not meet these five criteria is a report whose creditability is questionable:

- Completeness
- Accuracy
- Adequacy
- Relevance
- Reasonableness

Even if there are no applicable standards to assess, CAARR is essential to assist the trier of fact as to the report's creditability and reliability. Let's take a look at some examples.

Completeness

I was asked by a friend to look over an appraisal he did, as he wanted a second set of eyes on it before submitting to the attorney. This appraisal was being performed for a divorce matter. The business subject to the appraisal bought furniture in North Carolina to sell in Ohio parking lots. If you've ever been to the Midwest in the winter, you quickly realize that this is a seasonal business operating only from spring through fall.

Upon initial review, I immediately noticed that the revenues spiked considerably in the most recent year. As it turns out, although the appraiser had several years of financial records to work with, the most recent year was only for the months of May through October. Rather than obtain the full twelve months, the partial year was averaged to calculate to a full year. This averaging shortcut—which ignored the seasonality of the business—caused the revenue of the most recent year to be 3 times higher than any of the previous years, thereby causing a

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[1] Statements on Standards for Accounting and Review Services issued by the accounting and review services committee of the American Institute of Certified Public Accountants (AICPA)
[2] Professional Standards of the National Association of Certified Valuators and Analysts (NACVA)
[3] International Valuation Standards set by the International Valuation Standards Council (IVSC)

significant overstatement of earnings, which in turn caused a significant overstatement in the concluded value.

Be cautious to not let the fee or your time constraints dictate the scope of work. Take the time to get what you need and be fully thoughtful of the work you are doing.

Accuracy

Be cautious of mathematical and formula errors. Have someone check your calculations. The courtroom is not the place you want to be when you find out that something is wrong with a formula in your excel spreadsheet. This can happen easily when you have a case drag on or discovery comes in piecemeal. Say for example that you initially get financial statements for 2018-2021 and do your thing. But the case drags on. Now a year later you are asked to update your analysis with 2022 data. So, you add one more column to account for the additional year. Don't forget to go back and check ALL your formulas to account for new columns and new lines in your spreadsheets.

Adequacy

Regardless of budget, do not shortcut your research. A personal property appraiser with 20 years of experience valued residential contents for use in an estate tax filing. One of those items was a table he valued at $3,000 and ultimately sold at auction for $1,650. However, only 12 days later, that same table sold for $1.37 million. How did this happen? The appraiser/auctioneer based his value opinion on his personal experience rather than researching evidence to support his opinion. Shortcuts can cause significant oversights, which can lead to very unpleasant lawsuits against the appraiser.

Relevance

Are your facts straight? Do you know the applicable and relevant law for the matter at hand? In my state, the Standard of Value for divorce is Fair Market Value. And as we know, that means the price that a hypothetical willing seller will accept and a hypothetical willing buyer will pay, with all parties having knowledge of all relevant facts, and neither party being under any compulsion to buy or sell. One report I saw recently for a divorce stated that Mr. X wants to continue to do business as usual so there will be no goodwill to sell; only furniture, fixtures, and equipment is all that he is willing to sell. Let's not overlook the very important word "hypothetical" and phrase "neither party being under any compulsion…"

This same report failed the *adequacy* factor where it stated "unrecorded cash sales—none of those numbers are applicable to valuing a business." We are not IRS auditors, but we as appraisers have an obligation to ourselves, our profession, and our clients to include all relevant data. Exclusion of relevant data is certain to derive an illogical and incorrect conclusion. This report went on to say "In 41 years of business brokerage, my company never takes into account numbers that are not on the tax return." Of course unrecorded revenues are applicable. Sounds a little *ipsi dixit*[4] to me; with a touch of competency issues.

Reasonableness

A conclusion may appear reasonable on the surface, but look further. Normalizing adjustments to the income statement are made mid-stream to arrive at the final conclusion. Are the "normalizing adjustments" reasonable?

[4] Law.com, Legal Terms and Definitions, accessed May 2, 2023: Ipse dixit is Latin for "he himself said it," meaning the only proof we have of the fact is that this person said it. https://dictionary.law.com/Default.aspx?selected=1027

For example: Does it really make sense to adjust compensation for an owner who works full time to $100,000 based on some survey when the field supervisor who is not related to the owner's family earns $130,000? Look at what the respective individuals actually do, what their responsibilities are, and how many hours are actually worked.

Does it really make sense to adjust marketing and advertising one year to be consistent with previous years? Look at the details to see where those dollars were spent and why.

Does it really make sense to adjust employee benefits to remove the baby gifts and holiday turkeys to the employees? Employees value more than just paychecks. Employees want to feel like they are valued by the employer. If this is a longstanding practice and not discriminatory, leave it be. The term "discretionary" can sometimes be taken to an interesting level.

Or do you think some of these adjustments were made to accommodate someone's agenda? There is no room for agendas or advocacy in appraisal work.

Also be careful of blanket statements like "The business is worth nothing because it is not profitable." Jumping to this conclusion without sufficient evidence can easily get your analysis, report, and conclusion thrown out of court, causing significant damage to your professional reputation. A simple search on DealStats shows 9,150 transactions where the Target reported operating losses. Of those, 632 reported negative seller's discretionary earnings. If that blanket statement were always true, how could all of these transactions have happened?

Essential Concepts

Yes, CAARR is part of USPAP Standard 3.3. However, even if the Work Under Review is not subject to USPAP or any other stated standards, these five concepts are essential for a defensible appraisal and are useful to appraisal review professionals to assess the credibility of any appraisal work under review.

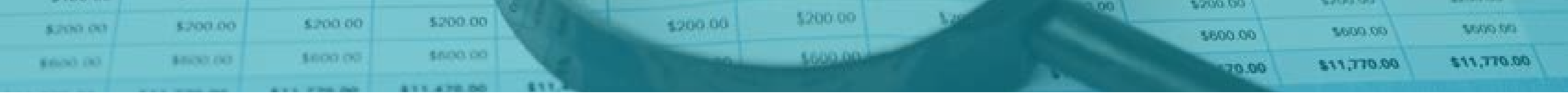
About the Author

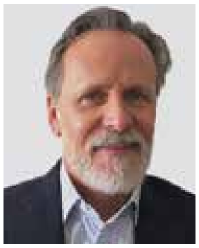
Terri Lastovka, ASA, ARM, owner of Valuation & Litigation Consulting, LLC in Cleveland, Ohio is an Accredited Senior Appraiser along with being accredited in Appraisal Review & Management with the American Society of Appraisers, and is also a Certified Public Accountant and an Attorney. Terri has more than 30 years of experience consulting in the areas of business valuation, litigation consulting, business practices, financial considerations, and tax issues.

Reviewing for Business Valuation

By Joao Mynarski, ASA

Abstract: While discounted cash flow (DCF) analysis is a preferred approach to valuing companies, such analysis can be susceptible to value discrepancies arising from the key factors of financial projections, discount rate and projection period. This article highlights some important issues regarding those factors and discusses how they might be considered in an appraisal review.





Discounted Cash Flow Analysis

Due to its practicality, discounted cash flow (DCF) analysis is widely used in business valuation and has become the preferred theoretical approach among academics and the favored tool within the financial community for valuing companies. This analytical model is based on the key factors of financial projections, discount rate and projection period. However, because DCF analysis is highly susceptible to value discrepancies arising from small variations to these factors, it seems appropriate look at its weaknesses with a view to ensure greater accuracy of business valuation reports. This article will address the three factors of period, discount rate and financial projections, discussing some important issues and offering some points to consider when conducting business valuations or reviewing business valuation reports.

Period

The length of the period covered by financial projections must represent the useful life of the company or the estimated period that the company will maintain its operations. How can we reasonably define this period? Market research, based on official institutes, questionnaires and consultation, conducted among similar companies seems to be the best alternative to define the useful life of companies and thus determine the period of financial projections. A valuation that assumes a company will keep operating forever (in perpetuity), fails to consider the life cycle of companies, and such theoretical reasoning is not confirmed in practice. If the valuation does assume perpetuity, some points require particular attention:

- The company should not be a startup, as projections are uncertain during this phase in company's life;
- The company must have a relatively good market share and generate sufficient cash to allow investments and overcome crises;
- The company must continuously invest in new technologies and innovations;
- The company must be constantly alert to new market opportunities;
- Any successor must maintain or expand on the above items;
- The company should not be subject to any great threat to its ability to do business.

These issues regarding financial projections need to be carefully analyzed to ensure business valuation reports are as accurate as possible.

Discount Rate

The discount rate is dependent on market fluctuations, but the market is made up of people susceptible to emotions (for example, enthusiasm, fear, and greed), which directly impacts stock pricing and interest rates and creates distortions.

When using data from the stock exchange to analyze companies, care needs to be taken to ensure the companies have the same scope, structure, and market share and whether the stock exchange represents the market under study If there are differences, the analysis will not be truly representative.

Sometimes it is more precise to define the business risk through a detailed questionnaire and local research than to use indices that do not represent the analyzed company.

Financial Projections

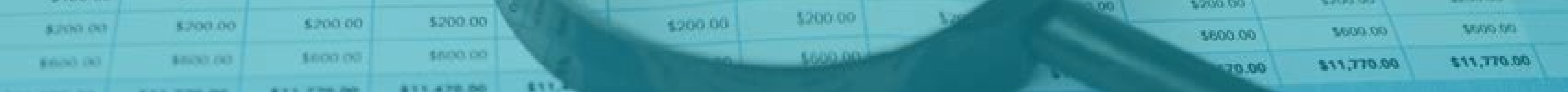
The reliability of financial projections is extremely important in business valuations, and precision diminishes the longer the period the projection seeks to cover. So, in the short term a projection might be highly reliable, but as time goes on the projection is likely to be less precise.

This diminished reliability arises from the difficulty of estimating future market changes and financial flows. Moreover, simply applying constant projections over the long-term aggravates this situation. It is more appropriate, therefore, whenever possible, to use variable projections that take into account the company's cycles and may even consider variations to income and expenditure during the projection period.

Analyses of the business plan, revenues, production capacities, market, technology, labor, risks, opportunities, and so on, make it possible to estimate the growth rate in the projections. Nonetheless, care must be taken during such analyses because each company is unique and, as such requires tailored treatment.

When preparing financial projections, we shouldn't forget to analyze the following items:

- The probability of bankruptcy is rarely considered;
- Long-term projections must be conservative, as they are based on fragile assumptions, with little foundation. Nevertheless, according to Berkman, Bradbury and Ferguson, Copeland,



Koller and Murrin and Buus the weight of the company's terminal value can be considerable (over 50%), which constitutes a very high risk for investors;

- If there is perpetuity, the perpetuity growth rate cannot exceed the economy's growth rate;
- Estimating the growth rate in the terminal period may be better accomplished using a detailed questionnaire than by macroeconomic or sectoral estimates;
- CAPEX should consider the remaining (productive) useful life of the assets and not the accounting depreciation rate;
- The feasibility of implementing the company's strategic plan must be verified.

Conclusion

The practicality of using discounted cash flow (DCF) analysis in business valuation depends upon the reliability of the key factors involved: the financial projections, discount rate and projection period. This brief commentary on issues to consider when determining these factors can be useful in the preparation and review of business valuation reports, and may stimulate feedback from the academic and professional communities interested in business valuation.

About the Author

Joao Mynarski, ASA, ARM, is the principal of Mynarski International Valuation in Latin America. Joao earned a degree in civil engineering in 1983 from Pontifícia Universidade Católica do Rio Grande do Sul. He went on to specialize in appraisal at UFRGS, Federal College of Economics; UCLA, Berkeley Extension; and IBEF, Institute of Finance Executives. He started Mynarski International Valuation in 1991; the company offers a full range of appraisal and valuation services, asset management, business combination and software development in all business sectors for corporations, investors and funds.

Organizing Reports for Focus and Understanding

By Jo Crescent, ASA ARM

Abstract: This article addresses the practical issue of organization in appraisal review reports, including discussion of introduction, conclusion, and how to group critical issues of the work under review (WUR) and use headings to guide the reader through the review analysis. Some examples from actual appraisal review reports are included.

Organizing the Appraisal Review Report

Like a road map, a well-laid out appraisal review report leads the intended user or other reader's of the report through the findings and analysis of the review environment to arrive at the desired goal: an understanding of the credibility of the work under review. USPAP explicitly states that "Standard 4 [Appraisal Review, Reporting] does not dictate the form, format, or style of appraisal review reports" and that "the substantive content of a report determines its compliance." USPAP does, however, place an extraordinary emphasis on the responsibility of providing a report that is understandable to the intended user(s), and many appraisal review reports are confusing. We've all seen review reports that read more like a check list or mash-up of facts and observations than a carefully considered presentation of the review analysis.

Let's consider how organization of those facts and observations—whether tightly focused on compliance with particular USPAP Rules or Standards or addressing the broader issue of CAARRs—might more effectively inform and educate a reader of an appraisal review report.

Introducing the User to the Review Analysis

Ideally, the review report will begin with a concise introduction. This may be a cover letter, but because a cover letter may not be considered part of the report, try discarding the traditional transmission letter—which is not required by USPAP. Instead, introduce the report with a few informative paragraphs, focus the user's attention on the two or three top problems with the WUR. This introduction will help to guide the user through the report. Here's an example:

> *Important areas of the WUR are incomplete, confusing or misleading. In particular, the WUR does not state the intended use, leading to lack of confidence in the definition of value used, and it does not provide adequate discussion of the analysis and research used for several key areas, including the 3 critical pieces of cost approach methodology: cost data, trend data and depreciation analysis.*
>
> *Because the WUR fails to comply with several areas of USPAP including the Ethics Rule, the Competency Rule, and the Scope of Work Rule, as well as Standard Rules 7 & 8, which are relevant to the specifics of Personal Property Appraisal, the work under review is not credible for its intended use in decisions relating to settlement of a family law dispute.*

“Like a road map, a well-laid out appraisal review report leads the intended user or other reader’s of the report through the findings and analysis of the review environment to arrive at the desired goal”

This appraisal review report points out specifics of non-compliance and discusses the importance compliance with USPAP Standards in creating credibility of appraisal reports. Discussion of minor considerations incidental to the overall credibility of the report, such as inappropriate vocabulary (i.e., "estimated Replacement Value" and "Summary report") are not addressed in this review report.

The user / reader now enters the review report environment with a heightened awareness, alert for your explanations of how the USPAP Standards neglected in the WUR are important to the credibility of an appraisal report. What happens next?

Providing More Background

While the user / reader may be eager to plunge into the unfolding of WUR problems, this could be a good spot in the report to lay a solid foundation for the analysis to come. Take this opportunity to cite any rules or standards referenced in the upcoming narrative so that users have an opportunity to draw their own conclusions as to how the rules and standards guide your analysis. This is also a convenient place to provide USPAP-required information for an appraisal review such as identification of the WUR, appraiser's name, WUR report date, and explanation of the scope of work, along with the relevant appraisal standards for the WUR , and USPAP Standards 3 and 4 (which regulate appraisal review development and reporting). The correct signed certification page could also be placed here.

A Note on IVS

An appraisal report that claims to be in compliance with IVS, USPAP, SSVS etc cannot be judged against the USPAP Development and Reporting Standards for its specific discipline. It can, however, be reviewed by an ASA ARM. In such a case, the review report should clearly that because IVS review standards are limited, the review is guided by USPAP appraisal review standards for completeness, accuracy, adequacy, relevance, and reasonableness as listed in Standard Rule 3.

Addressing Material Issues in the WUR

Lead with the most critical issue and address the others in order of importance. In writing sections, put the most important information in the first sentence. This is not the time for a long lead up to the punchline. The more efficiently the problems are presented, the more useful the report will be to the user. Looking back at the report I submitted for my ARM designation, I notice that the Material Issues section starts with the lack of a signed certification. Yes, it's a USPAP requirement but the most important issue to an intended user or a judge or jury would probably be that this WUR—which used cost approach to arrive at the opinion of value—provided no explanation of the three critical pieces of cost approach methodology. This issue was further detailed in the review report with questions about the validity of cost data, the choice of a proper trending index, and the calculation of depreciation factors, including the determination of normal useful life.

Groupings and Subheads

ASA's ARM POV classes teach the syllogistic writing process taught in law schools: IRAC and CRAC. IRAC (Issue, Rule, Analysis, Conclusion) and CRAC (Conclusion, Rule, Analysis, Conclusion) are useful in developing and presenting analysis and can be particularly useful for the appraisal review process, providing a straightforward structural guide that assists the intended user in easily following the review analysis.

Because these methodologies depend upon including the particulars of the Rule or Standard into the corresponding sections of analysis, where the connection is clear to the user, consider grouping areas of general concern, using subheads to address specifics. For instance, if most of the issues in a report fall under the Scope of Work Rule or a reporting Standard (2,4,6,8, 10), grouping those issues together may allow a single presentation of the Rule or Standard rather than inserting it for each issue, although specific Standards Rules should be included as appropriate.

For example, a main section on Standards Rules 7 and 8 might provide an overview such as

> Standards Rules 7 & 8 provide standards for development (7) and reporting (8) of personal property appraisals. An appraisal report's consistency in meeting those Standards provides insight into the knowledge and experience the Competency Rule expects of an adequately completed appraisal assignment.

This main section could be followed with a sub-section on the lack of minimum content that includes Standards Rule 8-1 and 8-2 (viii).

Alternatively, an appraisal review report could present an overall heading such as "Incomplete, Confusing, or Misleading Content" with a citation of the appropriate Standards Rule (8-1, for example) and then present each instance as a sub-headed section without further reference to that Rule.

When introducing a group of issues, the intended users will find it helpful to be offered a brief introduction into the areas of non-compliance about to be addressed. A sentence or two directly following the section heading will provide your readers a jumping off place into the specifics you provide:

> *Several areas of the WUR reduce its credibility. The WUR is based upon an incomplete and incorrect scope of work, ignores state regulations particular to the subject assets being appraised, uses questionable methodology in arriving at an opinion of value, and provides incomplete certification.*

Helpful Headings

Most reports will not need more than three or four heading levels; fewer can sometimes be more effective. All headings must indicate a change in information and direct the user to what is coming next in the report. Avoid confusing or unclear headlines. Don't be like one review report writer who under the heading "Approaches to Value Not Used" included the sales comparison approach (which was used) and didn't mention the cost approach at all.

Explaining the Issues

A report limited to listing the issues of the WUR and referencing related Standards or Rules will probably fail to educate the user. Many reports would be easier to understand with a few more words—explanations that adequately and clearly explain how the Rules and Standards help protect the user and validate the opinion of value. Don't assume that the user will make the necessary connection between what the WUR neglected and how that reflects on its credibility. Take the space necessary to explain why a problem is a problem, discussing the rule or best practice that addresses the particular issue: Don't just say, as one review report did, "This conclusion may be conclusory, with minimal analysis and explanation, and lacking adequate support."

Whether an appraisal review report is strictly addressing compliance with particular USPAP Rules or Standards or addressing the broader issue of CAARRs, the user will benefit from understanding which specific USPAP Standards have been neglected & how or which of the CAARR qualities are lacking in the WUR's discussion of methodology and analysis. In short, when addressing a specific issue, link it directly and clearly to a particular Standard or CAARR, and explain why the rule is important to the intended user.

For each issue, be clear that the report references only the WUR and not the appraiser who wrote it.

Concluding WUR Credibility

Make a strong concluding statement, restating and encapsulating the critical issues of the WUR. Remember that introduction? Share language between these two sections to reinforce and remind the user of the issues addressed, any discrepancies between the WUR and what one should expect from a credible appraisal report, given the appraisal industry's accepted standard of care as presented in USPAP, IVS, CUSPAP, SSVS, and so on. The report might also rely on other industrywide appraisal resources., such as Valuing Machinery and Equipment for equipment appraisals, Mandatory Performance publications from the Corporate and Intangibles Valuation Organization for business valuations, or the Appraisal Institute's The Appraisal of Real Estate for real property appraisals.

If the WUR should not be considered credible, state that clearly and summarize the reasons for your conclusion. Consider re-stating the important USPAP references. Here is an example:

> *While the WUR includes numerous irregularities in regard to USPAP standards, the critical issue for its credibility is inadequate disclosure.*
>
> *In demonstrating that the required research and analysis was performed and in clearly stating the appraisal problem, the report fails to provide complete, adequate, and reasonable discussion and explanation. USPAP Standards 7 and 8, which guide the specifics of Personal Property Appraisal Development and Reporting, specifically address the need for this information to support the opinion of value.*
>
> *USPAP Standard 8, which provides the reporting standards for personal property appraisal, states in Standards Rule 8-1 that "The content of an Appraisal Report must be appropriate for the intended use of the appraisal and, at a minimum ...provide sufficient information to indicate that the appraiser complied with the requirements of STANDARD 7"*
>
> *These reporting requirements are intended to ensure that any appraisal*

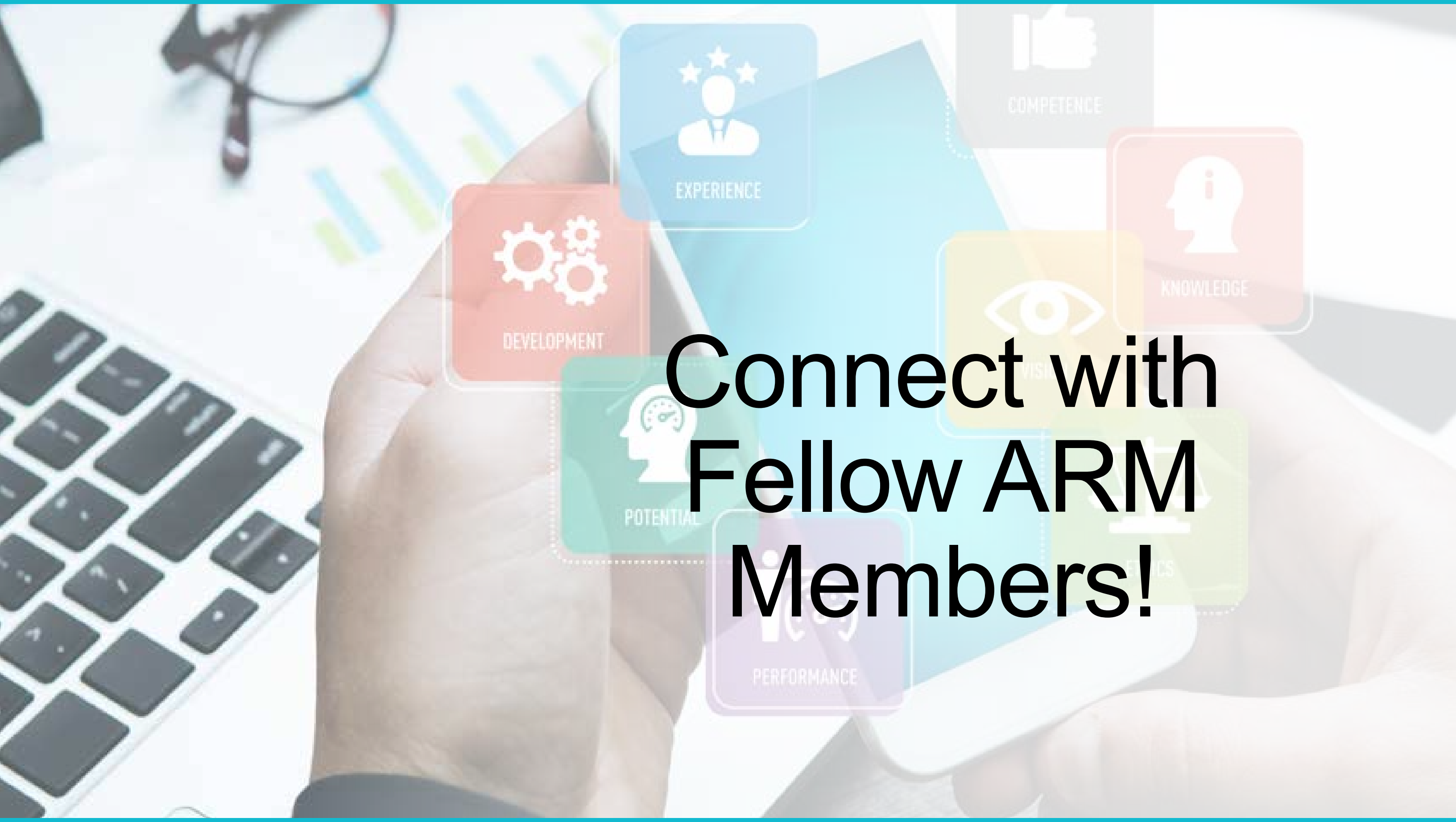
> *report will provide sufficient evidence and logic to support the opinion of value. The WUR does not* provide that information and thus its opinion of value cannot be considered credible or worthy of belief.

Finishing the Report

A strong, clear, and supported conclusion provides the user with a sense of closure and understanding. The review analysis has been introduced; a foundation of information on appraisal standards provided; the issues grouped into clearly titled sections and connected to the pertinent standards, whose benefit to the user has been plainly explained. Respected and accepted resources have been quoted and cited. Having been led carefully through an organized analysis of the WUR, any reader (intended user, judge or jury) should feel confident in the appraisal review report's evidence and diagnosis.

About the Author

Jo Crescent, ASA, is a partner and office manager at NorCal Valuation Inc. In addition to her ARM designation, she has taken several ASA Machinery and Equipment courses. She is content editor for the MTS journal and provided content editing for the current edition of Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets, published by the Machinery & Technical Specialties Committee of ASA.



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