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FEATURED ARTICLES

Top Ten Mistakes and Misconceptions in Report Writing

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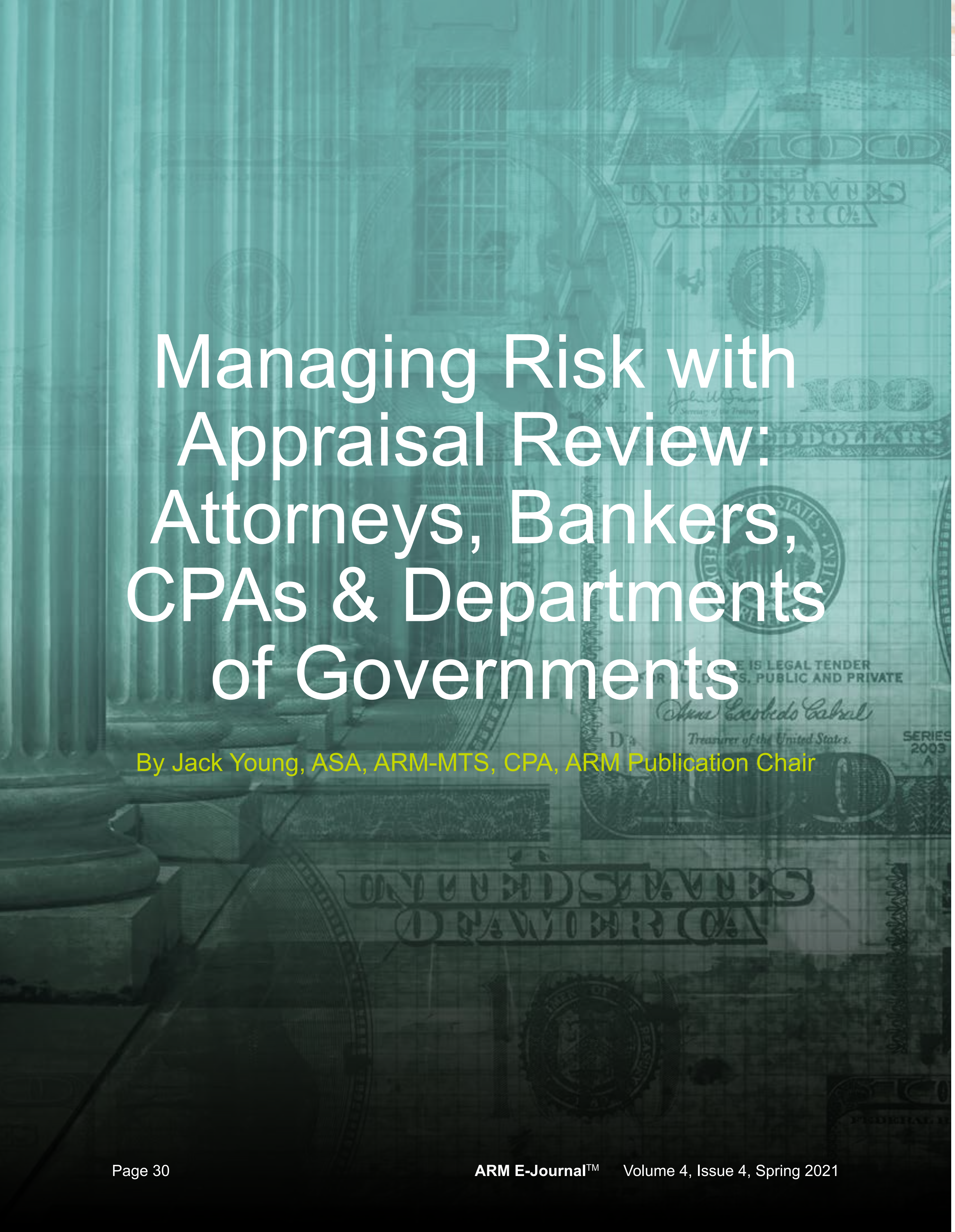

Managing Risk with Appraisal Review: Attorneys, Bankers, CPAs & Departments of Governments

By Jack Young, ASA, ARM-MTS, CPA, ARM Publication Chair

Appraisal review is about managing financial risk. The Appraisal Institute succinctly states that appraisal review plays "a critically important role … in risk management and mitigation for many clients/users of appraisal services."

The economy, as well as our legal and taxation systems depend upon accurate and reliable appraisals. Despite regulations and standards, however, some appraisals are flawed and misleading and can be a risky foundation for financial or legal decisions. Appraisal review determines the credibility and dependability of appraisals in order to reduce risk.

Which of the many users of appraisals have the highest risk exposure from a flawed or invalid appraisal?

- Attorneys
- Bankers & Lessors
- CPAs and CFOs
- Departments of government

Attorneys

Law firms involved in litigation, family law, and estate planning can reduce risk and increase validity with appraisal review services, especially in these situations:

- Family law
- Eminent domain
- Business dissolution
- Insurance settlements
- Bankruptcy
- Estate planning
- Property tax

Let's look at how appraisal review might reduce risk for situations of family law, business dissolution and insurance settlement.

Business Dissolution

Appraisals for the purpose of business dissolution, generally categorized as buy/sell, can range from family law (divorce) situations to a minority shareholder buy out such as regulated by California Corporations Code Section 2000. Depending upon the intended users/intended use, a valuation for business dissolution might only include the equipment or the real property. In other situations, a thorough business valuation is required.

A business valuation reviewer discussed two remarkable errors found in an appraisal report prepared for a business dissolution:

Reasonableness of Future Cash Flows

Valuations are required to assess all significant inputs used in developing an opinion of value. For business valuations, the Income Approach is typically used in the valuation of a going concern. The Income Approach is especially important as the value of businesses is predicated on the future cash flows to be received by the investor from the subject business.

In this case, the report uses projections of the future financial performance of the

company being valued without incorporating any discussion or explanation of procedures assessing the reasonableness of the projections. The valuation report does not comment on the ability to reasonably rely upon the projections to develop an estimate of value.

Consideration of Closed Facility

The valuation under review was intended to develop value for the total equity of a manufacturing company. The subject company had three manufacturing facilities that were operating profitably at or near capacity. The business had a fourth manufacturing facility that had been closed in the recent past. For the four manufacturing facilities, the business owned the land and building for each facility.

This report's valuation of the total equity of the parent company, however, did not include any adjustments to the income statements of the company for the expenses associated with maintaining the closed facility. Additionally, in the determination of the value of the total equity of the subject company, the valuation procedures did not include an adjustment to reflect the possible value of the closed facility.

Appraisal Deemed Invalid

Based on these two major concerns, along with a variety of other critical lapses from BV appraisal standard of care, the appraisal report was deemed invalid, and a more reliable valuation was produced for decisions related to business dissolution.

Insurance Settlement

An insured, who collects antique furniture and oil paintings, primarily landscape and still-life, hired an appraiser to appraise a number of items damaged in a flood. The insurance company submitted that report for a review, feeling particularly dissatisfied that the items had been assigned an "appraised value" rather than the "Fair Market Value" specified in the insurance contract.

Reviewing the report against the standard of care for personal property appraisal uncovered even more disturbing factors. Most questionable were that the report included no discussion or explanation of research, methodology, or analysis, as required by Uniform Standards of Professional Appraisal Practice (USPAP); many of the items appeared to be inadequately identified; the appraiser had no affiliation with any of the three main accrediting organizations for personal property; and the one information source credited, a local antique dealer who, according to the report "set forth his values based on his knowledge and expertise," was the dealer who had sold many of the items to the current owner.

Using this review, which included an opinion of value for Fair Market Value provided by the Judicial Council of California Civil Jury Instruction 3903K for Loss or Destruction of Personal Property (Economic Damage), the case was settled in mediation.

Bankers & Lessors

Reviews needed by bankers, lessors, or other financiers usually involve appraisals involved in one of three areas:

- Collateral loans
- Lease buyouts
- Special assets (aka bankruptcy)

Under Dodd-Frank bankers are required to obtain appraisal reviews when making loans with federal funds. Any appraisal for collateral loans and lease buyouts, however, is ripe for a valuation disaster, as one business owner discovered while preparing to liquidate an insolvent manufacturing

plant, he had purchased with an SBA loan. Relying on an appraisal that reported a liquidation value of the manufacturing equipment greater than the purchase price of the business, the owner took the loan, thinking that should the enterprise not pan out, the sale of the equipment would cover the loan. Within a year of the acquisition, the main client had left, and the enterprise was insolvent. Preparing for liquidation, the owner was shocked to discover that liquidation values in the report were inflated by about 50%. An equipment appraisal review using the standard of care for appraisal practice as set forth in *USPAP,* discovered that the appraisal was lacking in accuracy, relevance, and reasonableness: three of the five important qualities. In this case, an unreliable appraisal created a financial problem for the business owner and the financial institution that depended on this report.

CPAs & CFOs

CPAs and CFOs will benefit from reviews of appraisals that concern a variety of financial reporting situations in which they may find themselves having to provide advice or make decisions. Some specific areas are

- Estate: inheritance, step-up in basis
- Gift
- Purchase price allocation
- Insurance coverage
- Fair Value accounting, which demands a separate article (See Krieser's article in this edition)

The Financial Accounting Standards Board (FASB) dictates that the allocated purchase price of a newly purchased business must be assigned to designated categories such as inventory, land, buildings, equipment, and intangible assets (such as goodwill) in a process commonly referred to as "purchase price allocation." If none of those values are readily available, the purchaser will need appraisals for each physical aspect of the operation — land, buildings, and equipment — to accurately perform the purchase price allocation. The amount paid for the company in excess of the inventory, land, buildings, and equipment value is determined to be the value of the business's goodwill.

As you can imagine, an appraisal for the purpose of purchase price allocation that doesn't adhere to FASB regulations is a ticking time bomb. And an appraisal of this complexity has ample opportunity to invalidate itself.

Purchase Price Allocation

A review of a purchase price allocation appraisal for a dairy operation acquired by a larger corporation fell afoul of appraisal standards by valuing all equipment as Fair Value (FV), ignoring the Fair Value Accounting rule (ASC 820) that includes two different definitions of FV, determined by whether equipment will be sold as part of an on-going operation or sold by the piece:

> Fair Value, in-use: The price that would be received for an asset or paid to transfer a liability in an orderly transaction between marketplace participants at the measurement date assuming that the asset is sold as part of an on-going operation and assumes that the asset is sold and consequently operated with the other assets in the group.

> Fair Value, in-exchange: The price that would be received for an asset or paid to transfer a liability in an orderly transaction between marketplace participant at the measurement date assuming that the asset is sold on a stand-alone basis and independent of the other assets in its group.

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The purchasing entity's plans to shut down and sell one of the purchased processing facilities makes it is likely that some identical equipment involved in this purchase price allocation valuation will have materially different values. The equipment to be sold will need to be valued at fair value in-exchange, while processing equipment at other locations would be valued at fair value, in-use.

The reviewer further explained that a significant difference in these two values is that fair value in-exchange does not include installation costs, while fair value in-use does.

A more reasonable opinion of value, in this case, materially adjusted the amounts allocated to equipment and goodwill. A side effect was that the purchaser was able to lower property taxes as well as insurance coverage.

Departments of Government

Entities such as IRS, Department of Transportation, Department of the Interior, Parks and Recreation, County Assessor offices may find reviews useful in situations such as

- Eminent domain
- Property tax
- Estate & Gift

Eminent Domain

In eminent domain cases, the Constitution guarantees the property owner's right to fair compensation for the taking of property. Fair compensation is not determined by the taking entity. The property owner has the right to a court hearing to determine fair compensation. An appraisal review report explains flaws in the original eminent domain appraisal and can also provide an opinion of value.

In a situation involving the taking of agricultural land for public land access, an official at the Department of the Interior felt uncertain about the real property appraisal received. With the help of a real property expert's review, the department offered present the property owner a more reasonable and just compensation, avoiding a lawsuit.

The review uncovered three critical flaws in the original eminent domain report:

1. Although the property included three tracts of land that varied greatly in physical differences and potential use, the tracts were combined in the analysis with no discussion of their differences.
2. Improvements to the properties, such as roads, canals, fencing, ponds, and agricultural structures, were ignored.
3. Mathematical errors in the appraisal process created significant errors in the final values presented.

Managing Risk

Appraisal review is a good business practice that adds a level of due diligence to what is inherently a risky situation for users of appraisal services. How often have you sought out a second opinion for other situations, such as medical diagnosis or investment decisions? Appraisal review adds a level of due diligence to what is inherently a risky situation.

Appraisal review measures the credibility of an appraisal report by analyzing the appropriateness of the methods and techniques, reporting on whether appropriate data has been gathered and examined, if the data has been analyzed logically, and whether the conclusions are consistent with the information presented in the report. Appraisal reveals the appraisal's level of compliance with professional standards of care such as those mandated by *USPAP* and promulgated by credentialing associations such as ASA and AI. ■