



APPRAISING IN THE NEW MILLENNIUM

Due Diligence & Scope of Work



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A booklet by:
David A. Braun, MAI, SRA

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This booklet has been created by Automated Valuation Technologies, Inc. (AVT). AVT was founded by David A. Braun in 1993. The purpose of AVT is to fill the voids in appraisal practice that result from the rapidly changing appraisal environment. Appraisers often find themselves engaged in new activities, which quite frankly, they are not prepared to deal with. This is both unfortunate and unacceptable. It is unfortunate because appraisers are not fully effective in carrying out their duties. It is unacceptable because it compromises the vital role appraisers perform in the safekeeping of their country's greatest wealth (real property).

AVT operates under the belief that there is no substitute for the "Neighborhood Appraiser". Their knowledge of the local market is unique and cannot be duplicated by remote computer analysis. These local appraisers are hardworking and dependable. Without question, these gritty individuals will carry out their duties as long as they have the technical means to do so.

I would like to invite my fellow appraisers to download and use the "USL Documenter" which manages the common phrases presented in this booklet (see Addenda (C)). It can be accessed and downloaded at my company's web site "www.braunappraisal.com". There is no charge for this software. This application runs in Microsoft® Excel™ XP 2002 and newer within a windows operating system. You must have Excel loaded on your computer in order to run this software.

The Appraisers Research Foundation (TARF) contributed to the funding of this project. Their commitment was based on the basic concept of the general content, but the final work has not been reviewed by TARF. While the Officers of TARF agree with the importance and the timeliness of this subject matter they do not necessarily agree with the viewpoints and contents of the material presented. I want to thank the officers of TARF (Sherwood Darlington, MAI, SRA- President; Tim Leberman, SRPA- Vice President; and Joseph Stanfield, MAI, SRA- Secretary) not only for funding this project, but for their support of other projects as well. Their continued support of individuals and their ideas are an important cog in the overall advancement of the profession. Visit www.appraiserresearch.org for additional information about TARF.

ACKNOWLEDGEMENTS

This booklet is built on an accumulation of work accomplished and put forth by the appraisal profession. Thanks go to each person who has contributed to the improvement of the appraisal profession. Many have contributed by sacrificing their time, energy, and money. They may have served a professional organization at the local, regional or national level. Some have accepted positions that offer monetary compensation, such as the Appraisal Standards Board, or State Appraisal Commissions. These positions never pay enough for the time lost with their families, and businesses. Others may have shared their knowledge in the classroom, a book, or in an article. Some have contributed by the professional example they have set in their daily work.

No matter how large or small their efforts, they collectively reverberate into a hum that can be felt, if not heard. This energy perpetuates itself into each new generation of appraisers. These people have provided the common appraiser with not only the means to make a good living, but also to the ability to contribute to their societies thus receiving a great feeling of accomplishment and self-worth. Significant improvement in the appraisal profession can only be accomplished by working together.

I wish to thank Jack Bailey, MAI, SRA for his reviewing and editing this writing. Jack received a B.S. in Business Administration/Real Estate and Urban Development from the University of Tennessee. Jack has been appraising since 1984 and his practice has involved appraising a wide variety of commercial properties in numerous areas around the country. He has written and taught appraisal seminars for continuing education. Jack and I attended the University of Tennessee in the mid-seventies. It is certain that we attended many of the same classes; but we would not meet until some 20 years later when our two chapters of the Appraisal Institute merged.

ABOUT THE AUTHOR

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A PLACE IN TIME

In this new millennium appraisers find themselves not only in a new time, but in a new environment as well, which places new and different expectations on the real property appraiser. Appraisers are responsible for the ramifications that their opinions and conclusions have on the consumers they serve. The value of the appraisal is becoming measurable so the cost of our services must be less than the benefits we provide. Here appraisers must evolve from form-fillers and template masters to problem solvers. The purpose of this booklet Due Diligence & Scope of Work is threefold; first, to identify and explain these new surroundings so that the appraiser can regain his/her bearings, second, to develop concepts and theory, and third to provide a practical means of putting this knowledge to work in an appraisal practice. The first and second require knowing what to do; the third requires having the skills and tools to do it.

The significant problems we face cannot be solved at the same level of thinking we were at when we created them.

-Albert Einstein

Make no mistake about it, the profession has changed; appraisal practice is more complicated, competitive, critical, and demanding than ever. The rate of change in the appraisal industry has exceeded the rate of adaptation of most appraisers. As the demand for the *traditional* URAR report for mortgage lending continues to dry up, many appraisers are providing new and different services without understanding what the users of appraisals, USPAP, supplemental standards, or local laws expect of them. This practice of operating in the dark and hoping for the best is a state of chrysalis that places the appraisal profession, and appraisers, in a most vulnerable position.

The appraiser's growth and evolution in response to the changing environment is no longer optional. Appraisers must have the fortitude to transform their potential into competence and expertise. Much like a butterfly emerging from a cocoon, appraisers are discovering that not only have they emerged into a new environment, they themselves are quite different as well. They are finding that adaptation to change is becoming more natural. Preparing for the challenges ahead is just another part of their job. This booklet was written for this new breed of appraiser. It provides some of the basic knowledge and tools that are necessary for the appraiser to perform his/her job professionally in the new millennium.

Be forewarned that much of the knowledge and tools required to succeed in this new environment do not yet exist in the appraisal "body of knowledge". This booklet is not a rehashing of old principles and ideas, but is a presentation of several new concepts and tools resulting from an analysis of the new challenges and problems appraisers are facing. These new concepts and tools are

rudimentary and will need to be expanded and improved upon in the future. Over 35 definitions that are unique and specific to the understanding of this material are presented and prefaced with the infinity sign “∞”.

PLANNING THE APPRAISAL AND THE SCOPE OF WORK DECISION

Forming an opinion of the scope of work is just one step of the “Appraisal Planning Process”. The information assembled in the Appraisal Planning process is necessary to make the scope of work decision. In order to become proficient in making the scope of work decision it is necessary to break this process into many individual steps. This leads into a “Which came first the chicken or the egg?” situation. The scope of work decision cannot be made without planning the entire appraisal, and the planning of the appraisal cannot be performed without making the scope of work decision. In order to present the material in a simple and understandable way, the whole process is segregated into individual steps. The subject of this booklet is the entire “Appraisal Planning Process”. The following chart illustrates the appraisal planning process:

PLANNING THE APPRAISAL

I. Diagnose the Problem



II. Develop a Solution



III. Assess the Due Diligence

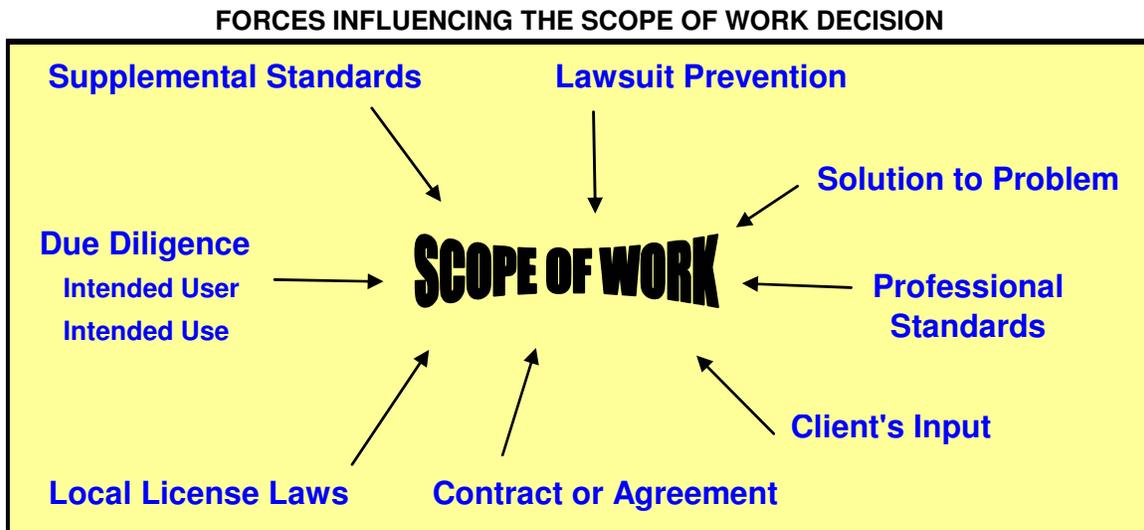


IV. Form an Opinion of the SOW



V. Communicate the SOW

It is important to understand that the scope of work is driven by several forces. A few of these are illustrated in the following chart:



Chapter 1 focuses on some of the events that have profoundly affected the appraisal business. The groundwork for *Planning the Appraisal* is laid by discussing three of the major driving forces of the scope of work; “Professional Appraisal Standards” are discussed in Chapter 2, “Civil Laws and Liability Management” are discussed in Chapter 3, and “Supplemental Standards and Agreements” are discussed in Chapter 4. The various Steps of the Appraisal Planning Process are covered in the following Chapters; Steps I and II are covered in Chapter 5, Step III is covered in Chapter 6, Step IV is covered in Chapters 7 and 8. Step V is covered in Chapter 9. Chapter 10 is a general conclusion to the booklet.

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CHAPTER 1 A CHANGING BUSINESS ENVIRONMENT

A CHANGING BUSINESS ENVIRONMENT

Almost all residential appraisers and most commercial appraisers have relied on mortgage based work as their bread and butter. However, more and more mortgages are being made without a professional appraisal as the collateral assessment product. Perhaps the biggest change over the past several years has been the raising of the minimum level from \$100,000 to \$250,000 for federally regulated lenders. The reality is that fewer appraisals have to be ordered. Some examples of this follow:

- The use of risk-based portfolio management practices.
- The use of risk-based examination practices by the Federal Regulators.
- Ignorance of the users of appraisals.
- Ignorance of the providers of appraisals.

Risk-based portfolio management models allow large lenders including government sponsored enterprises to vary the amount of diligence in the loan underwriting decision based on the perceived loan risk. This type of management plan has built in allowances for losses that are acceptable because of practices that cut origination costs. One of the cost cutting measures is the use of collateral assessment products that have less scope of work and therefore less reliability than the traditional appraisal. Some examples of these are; tax cards, automated valuation models (AVMs), limited appraisals without interior inspections, etc. In fact, limited appraisals presented on the 2055 form based on a curb-side inspection of the property may be the first example of the principle of the invisible hand affecting the appraisal profession on a wide scale. This Booklet validates the use of such practices in certain situations. However, the general public does not have an understanding of these new practices and does not know that appraisals have different degrees of reliability. Often, the borrower believes that any appraisal done on a property they are purchasing is reliable enough to protect them.

The Federal Housing Authority (FHA) takes a different approach and does not base the scope of work of the appraisal on the associated loan risk. FHA requires a complete appraisal on all loans that it insures.¹ Which system is better for the general public? In addition to dollars and cents, there are social issues to consider before it can be concluded which system is better (risk-based management systems or the current FHA process). Perhaps the purchaser's interests should be considered until such time as the general public becomes knowledgeable about the use of "special purpose" appraisals that are extremely limited in scope. A serious problem with both systems is the misguided belief

that the appraisal provides some assurances and protection to the borrower. After all, the borrower often has a legal right to receive a copy of the appraisal and worse it is often received before the loan is closed. It is very difficult to achieve public trust in a system that provides the borrower a copy of an appraisal that was never intended to protect his/her interests. This booklet does not address these issues from a right or wrong perspective. However, it does attempt to enlighten both appraisers and the users of appraisals as to the ramifications to the intended user of varying the scope of work in an appraisal.

Many purchasers believe that the appraisal the bank obtains will protect them because of the clause in many sales contracts that the buyer can back out of the sale if the appraiser's opinion of the value comes in too low for the loan to be made. Often, the collateral assessment product consists of a tax card, a curbside inspection by the loan officer, or some type of limited appraisal, none of which is adequate to protect the purchaser. If the borrower knows that the lender is going to use a limited scope appraisal for underwriting purposes he/she might wish to order an appraisal to provide information to help him/her make a purchase decision. The Tennessee Association of Realtors (TAR) has addressed this problem in their contracts. The TAR sales contract allows the purchaser to mark that the contract is or is not contingent on the appraiser's value opinion. What are the appraiser's responsibilities when he/she knows that the buyer intends to rely on the appraisal? This Booklet is intended to begin an education process for the providers and users of appraisals concerning such issues.

Let's start the learning process; does a purchaser of real property have to pay for two appraisals (one to protect the lender, and one to protect the purchaser)? No, one appraisal can be performed for both. An appraisal can be made to provide information for mortgage underwriting, and to provide information for making a purchase decision. In this case the Lender is the client (Federal Banking Regulations require that federally regulated banks select the appraiser), and the intended users are both the lender and the borrower. The scope of work must meet the supplemental standards of the lender, and the intended user with the higher due diligence requirements. This will usually be the purchaser.

Limited appraisals were often done for small second mortgage loans. "On October 1997, the FDIC, Federal Reserve, and state banking departments implemented a risk-focused examination processes."² One of the results is that home equity line of credits (second mortgage loans) generally referred to as HELOCs are often omitted from the examination. As a result many Federally Regulated Lenders are using valuation products such as tax cards and automated valuation models (AVMs) that do not meet regulations. This involves the valuation products used in conjunction with "exempt" real property loan transactions. The regulations clearly spell out the requirements for an "evaluation" which is the valuation product required for these transactions (see the requirements for an evaluation found in the Federal Regulating Agency's (FRAs) Letter Dated October 27, 1994 presented in Addenda (A). Recently I

discussed this situation via Email with an official in the Examination Department. My question and his answer follow:

QUESTION: Tax cards and AVMs do not meet minimum banking regulations. Why do examiners not enforce the 10/27/94 minimum requirements as defined for “evaluations”?

ANSWER: You are correct. Tax cards or an AVM must meet the guidelines content standards to qualify as an adequate evaluation. ... Let me emphasize that an AVM should not use a “black box” or “black magic” approach. That is, to meet the guidelines, an AVM should show the data, and should show the data analysis, that is used in estimating value.

Tax cards have different issues. On the positive side, owners of real estate property generally do not allow themselves to be over assessed. Therefore, tax assessments normally either reflect value, or understate value. However, the tax assessments often do not provide data on how the value is determined. To use tax cards as part of an evaluation, the bank at a minimum would need to document the assessment system used by the taxing authority results in uniformly accurate values. That analysis of the accuracy of the valuation system used by the tax authority could be held in a central file. Further, each tax card would need to be reviewed by the bank to determine if there were any unusual factors that could cause inaccuracies in the assessed value and that review would need to be documented in the loan file.

“No comment” by examiners does not mean a bank practice is deemed appropriate. Examinations are risk focused and examiners may not have reviewed the adequacy of evaluations during recent examinations.

In the Frequently Asked Questions on the Appraisal Regulations and the Interagency Statement on Independent Appraisal and Evaluation Functions dated March 22, 2005 the subject is also addressed In question #25.

Does a tax-assessment value from the local taxing authority constitute an evaluation? Can a loan officer who approves and/or recommends a loan conduct an evaluation if the market value that the officer develops in the evaluation does not exceed the tax-assessment value?

Answer: A value from the taxing authority alone is insufficient to be considered an evaluation. An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. If tax assessment information is used as part of an evaluation, the regulated institution should document the facts and analysis used to demonstrate that there is a valid correlation between the assessed values of the taxing authority and the property’s market value. In addition, an evaluation should describe the real estate collateral, its condition, and its current and projected use.

A regulated institution should ensure that an individual who performs an evaluation is independent of the loan production function. Simply restricting the size of a transaction to less than the tax-assessed value alone does not comply with the agencies’ appraisal regulations or the interagency guidelines, which address standards of independence. (See “Independence of the Appraisal and Evaluation Function” in the interagency guidelines.)³

The dollar amount of loans made each year based on a valuation product that does not meet federal regulations is not known. The impact of these regulation violations on the financial well-being of the banking system is beyond the scope

of this booklet. Clearly, the current method of risk-based examination procedures has resulted in less work for professional appraisers.

Ignorance of the users and providers of appraisal services is another concern to the status of the appraisal profession. Many banks simply do not understand the loss in reliability of appraisals that are circumscribed in scope. Unfortunately, many appraisers have no idea of how much the reliability is reduced by the omission of a specific task as well. The result is the situation of the blind leading the blind. It is not the purpose of this booklet to attack the use of valuation products that are less than the traditional appraisal; it is to disseminate information to the users and providers of appraisals, so that these products may be used appropriately. One of the reasons lenders are using valuation products that do not meet federal regulations is appraisers are not providing a uniform valuation product that is customized for exempt transactions. As an appraiser, I can say that the lack of both unity and farsightedness by our profession has been more than a small contributor to the problems appraisers face today.

Certainly these changes have been traumatic to the appraiser. However, one only has to read the newspaper to see that our industry has not been singled out to experience such changes alone. Many jobs in the USA have been lost to robotics, mergers, and offshore companies. The question remains how will the appraisal industry respond to these changes? Three possible plans of actions are illustrated below. Which plan is chosen will affect the future of the appraisal industry more profoundly than any outside force could ever do.

It is likely appraisers are more adverse to change in general than to the idea of matching the scope of work of an appraisal to the due diligence required. After all, the "Traditional" appraisal is limited in scope. Which typically does not include any of the following: a "B, C, or D" level market study, an economic based study, interior inspection and measuring of the sales comparables used, confirmation that the utilities have been hooked up, etc. The use of the traditional appraisal implies that the appraiser does not object to performing an appraisal that is limited in scope of work.



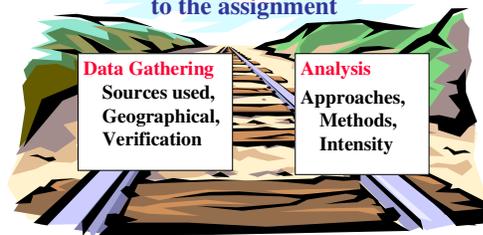
Plan B ...



Many have chosen Plan A which is to do a lot of grumbling and complaining. Unfortunately, no one seems to care, making this approach useless. Plan B was an alternative taken by a few appraisers. This plan was just to give up. Plan C is where most appraisers would enlist. It required circumscribing the scope of work for many appraisals.

Plan C

Only do the work necessary
to the assignment

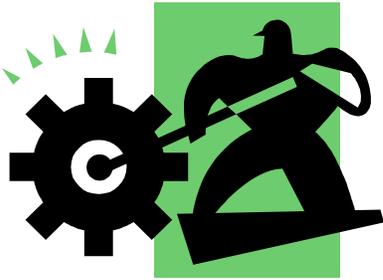


THE INVISIBLE HAND

It may be helpful to consider what forces interacted to cause lenders to use collateral assessment products other than the *traditional* appraisal and report. The answer lies in the economic forces of the free enterprise system. A business operating rationally will attempt to improve its position by maximizing income and minimizing costs. Appraisers are uniquely qualified to understand the operations of markets, especially the concept of market efficiency. Appraisers understand that market efficiency is a good thing for all concerned. The principle of the “Invisible Hand” was first presented by Adam Smith in 1776.⁴ Basically, it states that in a free market economy consumers will choose the lowest price and entrepreneurs strive for the highest rate of profit. The principle of the *Invisible Hand* is that the most efficient business will be rewarded and the inefficient business will have to close. In such a system the users of the products (general public) will benefit by having to pay less for goods and services.



Widget Maker's Use of Shipping Boxes



A widget maker named Dan makes three types of widgets. These have weights of 300 lbs, 200 lbs, and 100 lbs. The widget maker uses a shipping crate that costs \$30.00 and is rated for 300 lbs. He noted that he shipped out 1,000 widgets per month with an annual shipping crate cost of \$30,000 per month or \$360,000 per year. In order to capture more business he decided to use a crate rated for 250 lbs that cost only \$25.00 each. He calculated

that his crate costs would be reduced to \$300,000 representing a savings of \$60,000 per year. He was aware that a small percentage of the crates carrying 300 lbs of widgets would fall apart; however, the \$60,000 savings would make up for this inconvenience. He then dropped his prices by 5% and began capturing a larger market share.

One of his competitors named Sally noticed she was losing business but could not see how she could stay in business if she lowered prices. She hired a business efficiency consultant to help. After an extensive study of the widget business the consultant made the following suggestion: Use a shipping crate that matches the widget weight. That is, use a crate designed for 300 lbs to hold a 300 lbs widget, use a crate designed to hold 200 lbs for a 200 lbs widget, and use a crate designed for 100 lbs for a 100 lbs widget. At crate costs of \$30.00, \$20.00 and \$10.00 respectively then the crate cost to ship 12,000 units (one third of each weight) is \$240,000 per year and there should be no crate breakages. This is a \$120,000 savings over her current method of using all crates rated at 300 lbs. She now lowered her prices by 15%, a full 10% less that Dan charges. What do you expect Dan will do next?

This situation can easily be applied to mortgage lending. Think of the crate in the example as the appraisal provided. The widget weight is the risk associated with the loan. This explains that the lender is operating inefficiently when more money is spent on the appraisal than is necessary related to the transaction risk. Appraisers have a good understanding of an over- built improvement. They know that an improvement is a super-adequacy when the structure exceeds that required by the intended use. Much the same an appraisal can be a super-adequacy if it exceeds the requirements of the intended use. Most lenders are weighing the losses of foreclosures against the large revenues resulting from loan fees and cross sales.

Based on the deregulation of the federally regulated lenders and the principle of the Invisible Hand, lenders are behaving very predictably. It appears certain that the users of appraisals will require that appraisers provide appraisal services with varying degrees of scope of work.

The Appraisal Standards Board Concept Paper; The Roles of Departure and Scope of Work describe the situation as follows:

When USPAP was first developed in the late 1980's many real property appraisals were based on a "standard" scope of work, with minimal variations. In fact, the term "scope of work" was not widely used, because the scope varied so little from assignment to assignment. The degree of property inspection, the approaches to value applied, the extent of the research, etc. were determined by defined market norms. The prevailing philosophy seemed to be "one size fits all".

As conditions impacting the appraisal profession changed, demand increased for services other than the "traditional appraisal." While still using appraisal values, many large users of appraisals began to look at other factors in making business decisions. Like other professionals, appraisers needed the ability to provide a broader range of services to meet the legitimate need of clients.⁵

THE APPRAISAL PROFESSION RESPONDS

The Appraisal Standards Board (ASB) makes this bold statement; "Of all the judgments and decisions that an appraiser makes in the course of an assignment, the scope of work decision is by far the most critical."⁶ This is taken from "Concepts and Principles of USPAP- An Instructor's Application."

The appraiser must understand that his/her responsibility in regards to the Scope of Work decision is in effect today, not something that will be required in the future. The USPAP 2005 Edition states in part that, "An appraiser must have sound reasons in support of the scope of work decision and must be prepared to support the decision to exclude any information or procedure that would appear to be relevant to the client, an intended user, or the appraiser's peers in the same or similar assignment."⁷

This statement was also in the 2004, 2003, 2002, 2001, 2000, and 1999 editions. Early on there was little guidance for the appraiser in meeting this USPAP requirement. In 2002 the author of this booklet began research for the development of a seminar on the scope of work. At that time almost nothing was published on the subject. Users of appraisals were still largely satisfied with only a few types of appraisals. This explains why early on most appraisers and state appraisal commissions all but ignored Standard Rule 1-2 (f).

However, over the past few years users of appraisals have begun using appraisals with varying degrees of scope of work. The ASB has published additional information on the subject, and at least two educational seminars have been offered on the subject. Now, there is really no excuse for appraisers, users of appraisals, and state appraisal commissions not to be able to understand how to make a scope of work decision. This booklet is intended to provide information to appraisers, users of appraisals, state appraisal commissions, bank

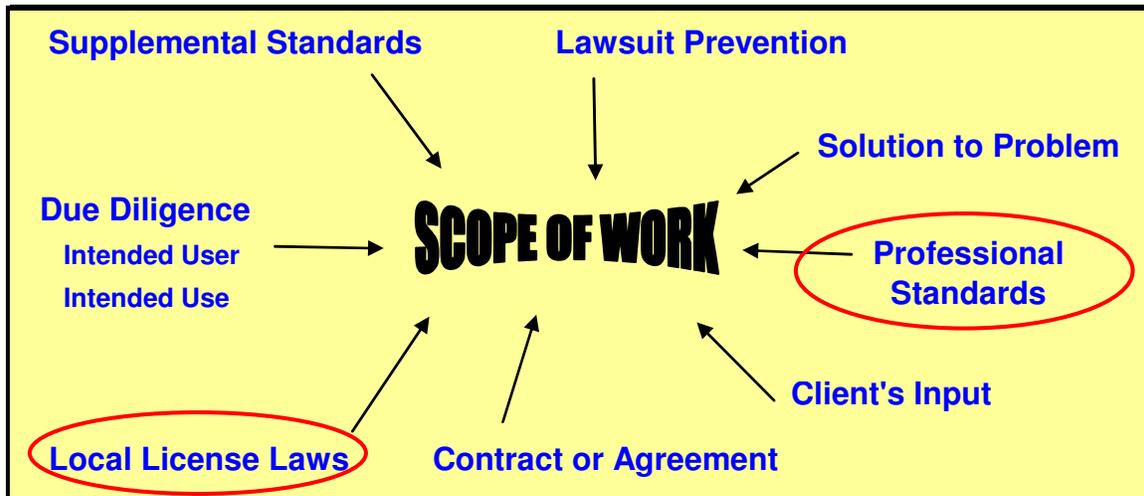
compliance officers, chief financial officers, error and omission insurance companies, appraisal management companies, financial regulators, software vendor companies, and others.

As appraisers find themselves in a state of transition where many types of appraisal services are offered for many uses, the appraiser is not sure of what his/her due diligence is, what is ethical to do (or not to do), or even what is legal. These concerns are addressed in this booklet. A fundamental framework of USPAP, Supplemental Standards, and Liability Management will be presented. An objective solution will be presented for the following questions:

- When have I met USPAP?
- How do I conform to supplemental standards? And,
- How do I minimize my liability?

CHAPTER 2 PROFESSIONAL APPRAISAL STANDARDS

FORCES INFLUENCING THE SCOPE OF WORK DECISION



Professional Appraisal Standards is a general term considered by most appraisers in the United States to mean the Uniform Standards of Professional Appraisal Practice (USPAP). In reality, it includes other standards as well. In this booklet we will consider *Appraisal Standards* to include International Valuation Standards (IVS), national standards such as USPAP, state laws that were put forth and are enforced by State Appraisal Commissions, and standards associated with the various professional appraisal organizations.

Professional appraisal standards are usually classified into two specific categories, Competency Standards and Ethics Standards. The competency requirements (Rules or Cannons) set the minimum work performance requirements. Ethics are intended to be the maximum requirements rather than the minimum requirements because an action is either ethical or it is not.

PURPOSE OF PROFESSIONAL APPRAISAL STANDARDS

Professional appraisal standards assure the general public that professional appraisers will provide credible services. This can be surmised from the following statements taken from the International Valuation Standards, USPAP, and the Code of Professional Ethics & Standards of Professional Appraisal Practice of the Appraisal Institute:

“Ethical conduct serves the public interest, sustains the trust financial institutions necessarily place in the services of Valuers, and works to the benefit of the valuation profession itself. It ensures that the results of valuations reliable, consistent, and unbiased.”⁸

“The purpose of the Uniform Standards of Professional Appraisal Practice (USPAP) is to promote and maintain a high level of public trust in the appraisal profession...”⁹

“Because of the vital role and the commitment of Appraisal Institute Members to professionalism, the Appraisal Institute has adopted its Code of Professional Ethics & Standards of Professional Appraisal Practice to establish requirements for ethical and competent practice. These requirements also serve to promote and maintain a high level of public trust and confidence in Appraisal Institute Members.”¹⁰

It is important to understand and begin to distinguish between the general public and the intended user of the appraisal report. The general public is made up of three categories; “Intended Users”, “Third Parties”, and everybody else. Each of the cited references above used the term “public”. While this usage is correct when used in this general sense, it can lead to confusion as third parties and court systems may take it very literally to mean that every appraisal performed by a professional appraiser will meet the needs of any and all of the public. This of course is the line of thinking that we are trying to avoid. The reality is that an appraisal that is credible for one user may jeopardize the user’s position if relied on by a different user or for a different use. The following definition may be clearer:

∞Professional Appraisal Standards: assurances to the general public that professional appraisers will provide services that are credible for a particular user and use.

In the next Chapter “Civil Laws & Liability Management” we will discuss the importance of clear warnings to the public that emphasize this point. It is beyond the scope of this booklet to address each of the professional appraisal standards. However, the USPAP is covered in an abbreviated fashion and used in some of the examples presented.

UNIFORM STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE

*There are times I almost think I am not sure of what I absolutely know.
Very often find confusion in conclusion I concluded long ago.
In my head are many facts, that as a student I have studied to produce.
In my head are many facts, of which, I wish, I were more certain I was sure.*

Roger's & Hammerstein's, "The King & I", as spoken by the King.

It sounds like the King just got out of a USPAP class!

There are four building blocks necessary to understanding USPAP. They are presented below and taken from the seminar "Scope of Work and Due Diligence" published by Automated Valuation Technologies, Inc.

1. The purpose of USPAP is to protect the general public.
2. USPAP sets the minimum standards.
3. The primary goal of USPAP, the State Appraisal Commissions, the individual appraiser, and in fact, the profession as a whole is identical.
4. How to properly develop the scope of work.

The Purpose of USPAP

The single most important step and the First Building Block to understanding USPAP is to recognize its purpose. USPAP is a set of appraisal standards designed to bring about a specific end result to the intended user's position. That's right, the intended user position. Who are the users of appraisals? A partial list includes individuals, CPAs, accountants, and lenders. Most licensing laws are established to protect the general public and the appraiser's licensing laws are no exception.

USPAP's Question & Answer Vol. 4, No. 4 April 2002 says the following:

- "Question #2: Is the main function of USPAP to protect appraisers?"
- Response: No. ...The intent of these standards is to promote and maintain a high level of public trust in professional appraisal practice."¹¹

When an appraiser performs an appraisal there are three possible results:

1. Making the user better off.
2. Making the user neither better nor worse off.
3. Making the user worse off.

The intent of USPAP is for the first of these to always be the end result. "Appraisers can't sell snake oil!" The medicine men that are often portrayed in movies of the old west sold bottles of mostly alcohol for various ailments. This left the users either worse off or the same. Occasionally they were better off, but this only lasted until the user sobered up.

USPAP violations occur on or before the delivery of the appraisal report. It is similar to drunken driving laws. Law enforcement agents do not have to wait until the driver does damage. The law, being concerned with the potential to do damage, allows for a drunk driver to be arrested immediately.

The three possible results listed above are rewritten to address USPAP's concern with the potential to do damage. When an appraiser performs an appraisal there are three possible results:

1. The potential to make the user better off: Credible.
2. The potential to make the user neither better nor worse off: Meaningless.
3. The potential to make the user worse off: Misleading.

Minimum Standards

The Second Building Block to understanding USPAP is recognizing that these standards set the minimum standards of appraisal work. However, it should be noted that while USPAP represents the minimum standards of practice it represents the highest standards of ethics¹².

No matter how little the appraiser does, he/she will have met the fundamental goal of USPAP if he/she has provided the information that contributes to the solution of the intended user's problem.

When the appraiser's scope of work results in opinions and conclusions that have a wide range of reliability, he/she can expand the scope of work and

increase the reliability. This is why USPAP is considered to set the minimum standards required to promote public trust.

Some state commissioners feel the best way for them to protect the general public is by enforcing USPAP as the maximum standards. This reasoning is outdated and not consistent with the principle of the “Invisible Hand”. These commissioners must relate this situation to the super-adequacy principle in appraising. If they were in charge of builders then they would be sure the occupant’s needs are met. But, they would understand that the market will not pay dollar for dollar for super-adequacies: it would not be fair to the public and it would put the builder out of business.

Goal Relationships

The Third Building Block to understanding USPAP is recognizing relationships between the goals of USPAP, State Commissions, the individual appraiser, and the appraisal profession as a whole. *Consumers will find an alternative way to solve their problems if appraisers cannot or will not solve their problem. Can you think of any ways the appraiser has been bypassed over the past several years?*

- The deminimis level was raised from \$100,000 to \$250,000.
- Non-licensed individuals are now allowed to estimate values for federally related banks when the transaction amount is below the deminimis level.
- Many loans are being secured by properties only evaluated by a tax card.
- Fannie Mae and Freddie Mac are using automated valuation models to evaluate the quality of a large number of loans.

It is a certainty that if the appraiser’s work is not done credibly, we will put ourselves out of business. The point is that professional appraisers and the state commissions should have no problem working together, since they have common goals. The working appraisers should support their commissioners as much as possible. The commissioners should likewise support the working appraiser. The commissioners must recognize that the most functional appraisals are the ones in which the relationship between the problem to be solved and the scope of work required to solve it are balanced, i.e. enough work was done, but not an overkill. While the appraiser’s work must be *credible*, it must also be *cost effective*. Consumers should not be forced to buy a Cadillac when only a VW Beetle is needed. Therefore, the relationship between the problem to be solved and the appropriate scope of work required to solve it must be recognized. It is harmful to the general public for appraisal services to be super-adequacies that are (needlessly time consuming and therefore unnecessarily expensive to produce.)

The appraiser should see his/her role as:

- Providing credible work
- Promoting a balance between the amount of work done and the problem to be solved.

Scope of Work

The Scope of Work is the Fourth Building Block to understanding USPAP. It is defined in USPAP 2005 Edition as:

“The amount and type of information researched and the analysis applied in an assignment. Scope of work includes, but is not limited to, the following:

- the degree to which the property is inspected or identified;
- the extent of research into physical or economic factors that could affect the property;
- the extent of data research; and
- the type and extent of analysis applied to arrive at opinions and conclusions.”¹³

Often appraisers who are beginning to perform assignments that are different than what they are used to doing express a fear that their work may not be meeting USPAP.

Five Tests for USPAP Compliance

1. That the opinions and conclusions contribute to the solution of the intended user’s problem.
2. That the binding requirements found in USPAP Standard Rule 1 are performed.
3. That the minimum reporting requirements in Standard Rule 2 of USPAP are met.
4. The appraisal is consistent with what the appraisers peers would produce, and meet the expectation of the intended users.
5. That the work is done in compliance with any applicable supplemental standards.

Test Number 1: is discussed in the “First Building Block” presented earlier in this section. Simply put, if the intended user’s problem is not solved, or the information to solve the problem is not provided, the appraisal has to be either *meaningless* or *misleading*, neither of which is acceptable to USPAP.

Test Number 2: consists of SR1-1 (a)-(c), SR1-2 (a)-(h), 1-5 (a)-(b), and SR 1-6 (a)-(b). These represent 15 binding tasks. You may notice that I have not mentioned any specific requirements. These are considered in Test Number 1. Some of the specific requirements may have to be performed in order to solve the problem. However, if the problem can be solved without performing them

then they are not necessary. You would technically be performing a limited appraisal because you have departed (not performed) some of the specific requirements, but you would still be performing a credible appraisal.

Test Number 3: requires that you meet the reporting requirements as presented in Standard Rule 2 of USPAP.

Test Number 4: Serious students of USPAP will recognize Standard Rule 1-2 (f) found in the 2005 edition of USPAP which follows:

“The scope of work is acceptable when it is consistent with:

- the expectations of participants in the market for the same or similar appraisal services; and
- what the appraiser’s peers’ actions would be in performing the same or similar assignment in compliance with USPAP.”¹⁴

USPAP lists only these two tests for determining if an appraisal is credible. Appraisers should be aware of their state’s appraisal commission’s interpretation. It is the author’s opinion that it is not logical that these are the only or main tests for three reasons. First, it is not consistent with the “Goal Relationships” described earlier in this chapter which state that the scope of work must result in the solution of the problem or provide the information for the intended user to solve the problem. Second, the last part, “...in compliance with USPAP.” is circular in nature. If the appraisal conforms to USPAP then no test is needed. The third and most compelling reason is because prior to the Appraisal Foundation the scope of work was indeed decided on by the users and providers of appraisals. History tells us that that system does not work. In fact the “Purpose of the Uniform Standards of Professional Appraisal Practice (USPAP) is “... establishing requirements for appraisers.”

These tests should serve as additional tests of the appropriateness of the scope of work only when it is not conclusive as to whether the intended user’s problem has been solved or that the information necessary to solve the problem has been provided.

Test Number 5: is not discussed here as it is the topic of Chapter 4.

Conclusion

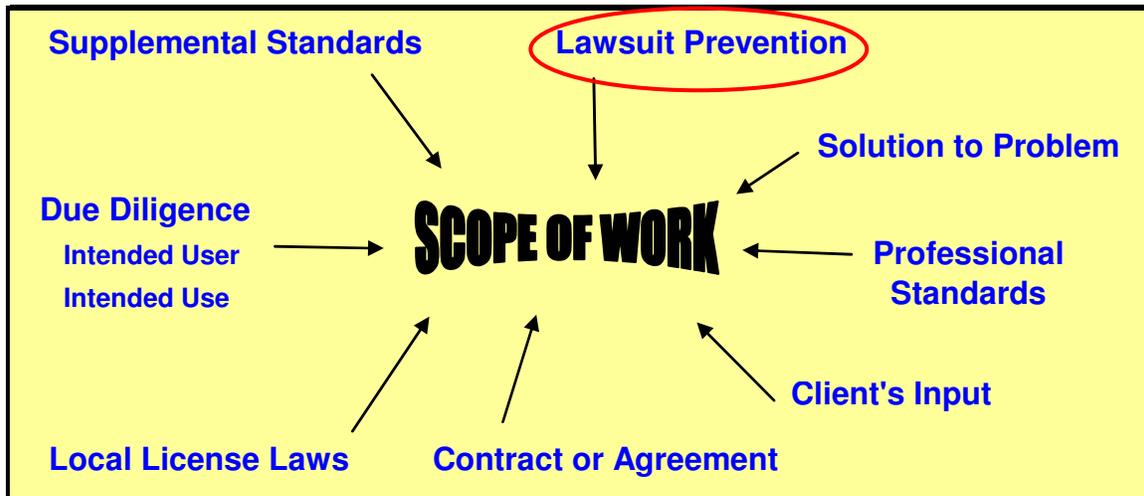
Thomas D. Boyle, MAI constructed a table listing the mandatory requirements as dictated by USPAP. His article, “USPAP-The Bottom Line: What to do, What to Write” was published in The Appraisal Journal, Volume LXXII, Number 4, Fall 2004. A summary of part of that table is presented below:

For all appraisals an appraiser must:

- Adhere to:
 - Ethics Rule
 - Competency Rule
- Adhere to (as applicable for assignment)
 - Departure Rule
 - Jurisdictional Exception Rule
 - Supplemental Standards Rule
- Understand and use recognized methods/techniques
- Develop exposure time opinion
- Not be careless or negligent
- Identify:
 - Client and any other intended users
 - Intended use of assignment results
 - Type and definition of the value to be developed
 - Effective date of assignment results
 - Relevant subject characteristics (location and physical, legal, and economic attributes; property interest valued; personal property, furniture, fixtures, and equipment or intangible items included; various real property restrictions; leases; fractional interest, physical segment, partial holding)
 - Scope of work
 - Extraordinary assumptions
 - Hypothetical conditions
- Apply valuation methods needed to result in a credible and adequately reliable assignment result relative to intended use of assignment results
- Reconcile data and approaches
- Not omit an approach to value that is typical practice or that peers would require unless adequate and reasonable support¹⁵

CHAPTER 3 CIVIL LAWS & LIABILITY MANAGEMENT

FORCES INFLUENCING THE SCOPE OF WORK DECISION



LIABILITY MANAGEMENT



The threat of lawsuit has become a factor appraisers consider in the operation of their appraisal practice. Several years ago changes occurred in the appraisal industry, one of which was the users of appraisal services requiring appraisers to carry errors and omissions insurance (E&O). Many appraisers have had a legal suit brought against them or have been threatened with one.

The good news is that most of these suits are dropped or the appraiser and E&O carriers make the business decision to settle for small dollar amounts. What has ushered in these lawsuits?

There are several reasons: the general public is unfairly lawsuit happy; attorneys are not penalized for promoting unfounded lawsuits; the legal system encourages "shot gun" lawsuits (almost everyone is included); the enforcement of professional appraisal standards is becoming ineffective; and as more appraisers carry E&O policies our pockets get deeper. However, for all of these unfair reasons that appraisers are sued our profession must accept some accountability to the clients which we serve. It is naïve to think that as the appraisal industry crosses the threshold to a profession that only the rewards will increase and not

the responsibility. After all, a professional should know what he/she is doing and have the fortitude to do a professional job. Professional Appraisal Standards were discussed in the previous Chapter. These differ from civil laws as they make assurances, while civil laws provide an avenue for remedies. The intent of these legal systems are rooted all of the way back to the Declaration of Independence;

“We the people of the United States, in Order to form a more perfect Union, establish Justice, insure domestic Tranquility, provide for the common defense, promote the general Welfare, and secure the Blessings of Liberty to ourselves and our Posterity, do ordain and establish this Constitution for the United States of America.”¹⁶

The keyword here is *Justice*. To achieve its purpose a legal system must operate with a clear understanding of the situations at hand. While most would agree that a professional has some responsibility and accountability to those that rely on their work, there is concern that courts may not recognize the shift in the business environment that has required appraisals to be customized for each assignment. A court could make poor judgments if it operates under the misconception that all appraisals are produced with the same degree of reliability.

Often an appraisal is used to justify why the client or intended user took a specific action. Some examples are; Taxpayer to IRS, Lender to Borrower, Lender to Regulators, Purchaser to Seller, etc. In such cases the appraiser knows that the appraisal will be seen by parties other than the named client and intended user, but the appraiser does not intend for these parties to rely on the appraisal. However, because the general public does not understand that today each appraisal is customized for a specific use and a specific user some of these parties will use the appraisal inappropriately.

*According to E&O companies approximately 65% of claims against property appraisers are made by third parties.*¹⁷

A third party is defined as follows:

∞Third Party: Any person or entity, other than the stated client or intended user that has access to an appraisal report.

An example would be an appraisal intended to be used as a collateral assessment product for a low risk second mortgage transaction. The appraisal was based on a qualitative sales comparison approach where the appraiser viewed the subject property from the curb. The lender gave the borrower a copy of the report to justify the amount they were willing to loan. The borrower later used the appraisal to set a sales price for the property. The borrower entered into a contract to sell the property at the appraised value. A second appraisal was performed in conjunction with the buyer's loan. It was based on a visual inventory from the interior and exterior of the subject property. This appraisal took into account the remodeling of the house three years ago and a 400 square foot addition not on the tax card. All in all, the second appraisal came back with an opinion of value some \$20,000 more than the first one. The third party (seller) filed a law suit against the first appraiser as he feels he was damaged some \$20,000 by relying on the first appraisal. The first appraiser bases his defense on the fact that the seller was not listed as an intended user, and that the appraisal was not used for its intended use.

What will happen next is dependent upon the laws of the individual state that this happened in. In this situation a few states tend to favor the professional, a few states favor the third party, and most states are somewhere in between. Several new factors are resulting in an evolution of laws relating to real property appraisers. The general public and courts are being introduced to the concept that all appraisals are not designed to meet every use, for every possible user. While almost all related state laws were written before USPAP was created, new laws may consider USPAP in their development. Over time, state laws and USPAP may begin to align, but because most cases are determined by precedents (previous cases) it may be a long time before this takes place. In the mean time appraisers can limit their liability in several ways.

GOOD BUSINESS PRACTICES THAT REDUCE LIABILITY RISK

Legal advice is beyond the scope of this booklet. However, it is appropriate to discuss some business practices that may lead to improved liability management for appraisers.

1. Become educated on consumer protection laws in your state.
2. Do not work for clients that have a low regard for ethics and professionalism.
3. Be cautious of entering into contracts.
4. Do not accept assignments that you are not competent or not willing to become competent to perform.
5. Do not accept assignments that represent a high potential for liability unless the fee is sufficient to allow adequate time to perform the level of data gathering and analysis that is appropriate for the assignment.
6. Understand the intended user's problem.
7. Provide the information pertinent to the problem in context of any applicable bodies of authority.
8. Clearly communicate the scope of work, limiting conditions, general assumptions, hypothetical conditions, extraordinary assumptions, and any contingencies.
9. Document the appraisal report with appropriate warnings to potential third parties that may be ignorant to the fact that the assignment is specific to a use and an intended user.
10. Most importantly perform your work ethically.

Become educated on consumer protection laws in your state.

The first is to get educated on the local laws. Find out what your state's posture is concerning third party rights. Take a continuing education seminar on liability management. Obtain advice from your E&O carrier on "good business practices". A good attorney should be involved in the development of the appraiser's liability management plan. It is important that the attorney you consult have experience in professional liability. You might try calling your E&O carrier for a reference to attorneys that they use in your area.

Do not work for clients that have a low regard for ethics and

professionalism. This includes theirs and the appraisers. This can be verified by an experiment. You will need a bucket of mud and one white glove. Put the glove on and stick it into the mud. Pull the hand and glove out of the mud. Measure how much mud is on the glove. Finally, measure how much of the white of the glove is left in the bucket.

The bottom line is that most clients are biased for their interests. If they carry this too far they may expect the appraiser to lean in favor of their position. As soon as this becomes apparent the appraiser should attempt to drop the assignment. This may not be possible, but the appraiser should not accept additional work from these types of clients. An appraiser was recently engaged by the middle of three brothers to consider the equitable division of their father's farm who had recently passed away. The middle brother (client) identified his other two brothers as intended users of the appraisal report. He contended that his older brother's tract was more valuable than his and the younger brother's tract. The appraisal confirmed this as true. However, the client was unhappy with the results of the appraisal as it also showed that the client's tract was more valuable than the younger brother's. This is an example of a client with whom the appraiser should have no future dealings.

It may be difficult to gauge a client's regard for professionalism; however, there is one test that is accurate. Clients and people in general expect to pay for the services of a professional. Anytime a client asks an appraiser to work for free, he does not perceive that appraiser to be a professional! This is the problem with clients that request an appraiser to pre-comp a property. Most pre-comping is allowed by USPAP as long as the appraiser treats it as a legitimate assignment. This means there is time in documenting a work file and following reporting requirements, as well as doing the pre-comping. An appraiser could easily spend an hour or more if he performs the pre-comping properly. The problem is that most clients do not intend to pay the appraiser for this service. The appraiser thought the client ordered a pre-comp, but in reality the client ordered a "free-comp". Our office recently had a potential client explain his need for a pre-comp as "If the deal is not going to work, we do not want to waste the borrower's time or ours". Why did this potential client not have any concern about the appraiser's time? Simple, he does not perceive the appraiser to be a professional. It would be inappropriate to state here what he does perceive the appraiser to be. This would be a good client avoid. However, it would be all right for an appraiser to work for a client that requests a pre-comp and intends to pay the appraiser for his/her efforts.

Be cautious of entering into contracts.

While there are many situations where an appraiser might enter into a contract, one particular example is discussed here as an illustration. Many residential appraisers are doing work for appraisal management companies (AMCs). Most AMCs require that the appraiser sign a contract in order to do business with them. Typically the contract will have a "hold harmless" clause of some type. This clause basically protects the AMC by requiring the appraiser to reimburse the AMC for any expenses which they incur related to the appraiser's work. This could mean that if the AMC is sued relating to an appraisal and spends \$10,000 on attorney fees the appraiser would have to reimburse them for that expense. Typically, an appraiser's error and omissions carrier will not automatically honor a hold harmless agreement. They have a strong conviction that appraisers

should only pay damages when they resulted from a bad appraisal, not for stupidity, that is, the stupidity for signing the hold harmless agreement in the first place. The author of this Booklet confesses to being a member of that club. My wife once asked me why I signed a contract with a hold harmless clause. I explained that I wouldn't have if I had read the contract. Since then we have refused to agree to hold harmless agreements and encourage appraisers to read all parts of any contract and seek legal advice from an expert before entering into any written agreement.

Do not accept assignments that you are not competent or not willing to become competent to perform.

This is self explanatory.

Do not accept assignments that represent a high potential for liability unless the fee is sufficient to allow adequate time to perform the level of data gathering and analysis that is appropriate for the assignment.

This includes complex properties, high value properties, properties in unfamiliar locations, etc. Liability management does not mean turning down the difficult assignments. It just means taking whatever time and effort is necessary to produce credible opinions and conclusions. Appraisers should turn down few assignments as it is in the profession's best interest to serve all of the needs for appraisals. However, the client may not be willing to pay the fee that you must charge to do a professional job on the difficult assignment.

Understand the intended user's problem.

This will be discussed in Chapter 5.

Provide the information pertinent to the problem in context of any applicable bodies of authority.

This includes organizations that set appraisal standards (See Chapter 2), organizations that set supplemental standards (See Chapter 4), legislatures that make local laws (This Chapter), and appraisal commissions that have sponsored appraisal laws which they enforce (see Chapter 2).

Clearly communicate the scope of work, limiting conditions, general assumptions, hypothetical conditions, extraordinary assumptions, and any contingencies.

Many appraisers have included the phrase from USPAP 2005 page 31, Lines 1041 and 1042 in their Certification. This phrase states; "the reported analysis, opinions, and conclusions are limited only by the reported assumptions and limiting conditions... ".¹⁸ This phrase says exactly what should not be said. A good attorney would ask the appraiser in the above example if he/she did not certify in the report that the scope of work did not limit the reliability of the

opinions and conclusions. It says they are limited only by the reported assumptions and limiting conditions. The good news is that USPAP only requires the appraiser to use a “certification that is similar in content to the...”¹⁹ one presented. Appraisers should consider modifying this statement to say, “The credibility, for the stated use by the stated user, of the reported analysis, opinions, and conclusions are limited only by the reported assumptions and limiting conditions... “. Credibility can only be measured in relation to the due diligence associated with the specific use and user. This subject is further discussed in Chapter 9.

Document the appraisal report with appropriate warnings to potential third parties that may be ignorant to the fact that the appraisal is specific to a use and an intended user.

It may be difficult to explain to a court why it was not suitable for a third party to rely on an appraisal. Today, the clients and intended users of appraisals have a more singular interest in the appraisals they order, which has resulted in limited scope of work appraisals becoming the norm. The client sees no reason to pay for any work that is not applicable to his situation (problem). The riddle is, how can an appraisal be customized for a specific user and use, and still be suitable for any third party to use for any other use? The answer is that it cannot be. Until the laws are changed one by one, the appraisal profession will have some difficulties. It is my belief that most legal systems make an extra effort to protect the vulnerable from predators, especially those predators that are making excess profits from the vulnerable general public. Certainly, “excess profits” is not an issue in the appraisal profession. A good judge, like a good appraiser will rely on common sense. The responsible appraiser will understand that most third parties are ignorant to the dangers of misusing the appraisal and will attempt to warn them. This can be done through notation in the appraisal report. This warning should clearly communicate to third parties that use of the appraisal may put them in jeopardy. This proactive communication designed and intended to protect these third parties will also minimize the appraiser’s liability to them. While the author is not a legal expert some examples of these types of warnings follow:

Regardless of who pays for this appraisal the intended user is ABC Bank ONLY. The scope of work in this appraisal has been customized for the intended user. It may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of the report, this appraisal may not be used or relied on by anyone other than the stated intended user. The appraiser, appraisal firm, and related parties assume no obligation, liability, or accountability to any third party. If you are not the stated intended user contact our office to have an appraisal customized for your needs.

The intended use is for mortgage underwriting. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use. Please contact our office to have an appraisal customized for your needs.

Consider putting similar warnings on the cover of the report. The effectiveness of any warning will be affected by the location and print size. After all, the intent is for third parties to see and read the warning. While USPAP has used the term "Restricted Use Report" for one specific type of reporting method, all reports are restricted use reports, as they should only be used by the intended user for the intended use. These warnings may discourage misuse of the appraisal report by third parties, protecting them from potential damages. Certainly, a judge would look on this favorably, as a predator typically does provide warnings to their victims. These warnings should be written in simple language, stated in a predominant place in the report in regular sized font that reliance on the appraisal report for any use except the stated intended use will jeopardize the user, and why.

E&O insurance is legitimate because even the best appraisers can miss-measure a building, or make a mathematical error. During a career several of these inadvertent errors may occur. Your E&O carrier basically collects funds from many appraisers in order that the cost of any justified settlement is spread among the group of appraisers that they insure.

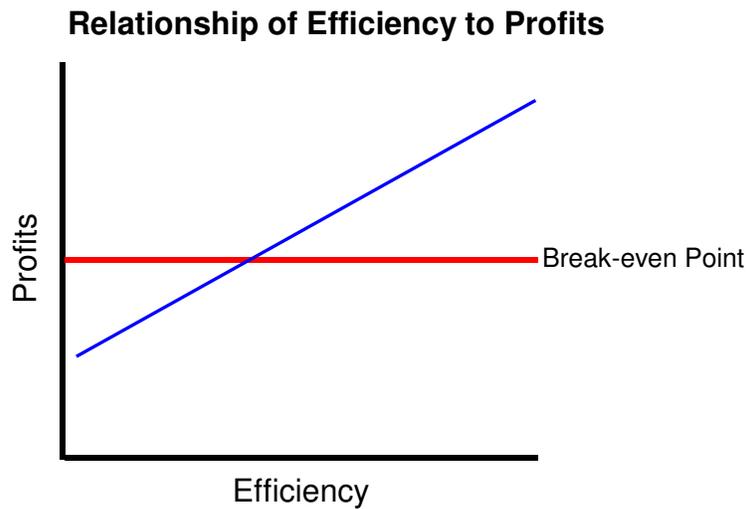
Most importantly perform your work ethically.

Remember, your E&O Company will only defend an honest mistake. They do not underwrite the risk associated with fraudulent activity.

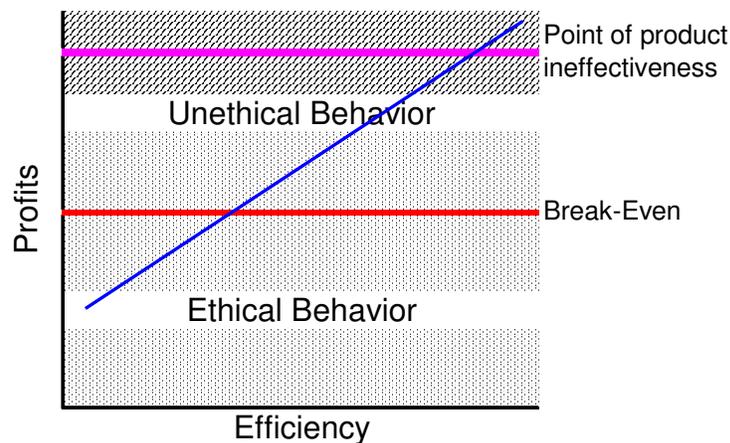
Be certain that all of your statements concerning the scope of work performed are actually done. Often appraisers include standard canned phrases, limiting conditions, and certification which state that certain things were done, when in fact they were not done. Dishonesty is stating or representing something as fact when the appraiser knows it is not true. A simple statement in the report that "the appraiser has inspected the comparable sales from the street, in conjunction with this assignment" when the appraiser did not do this is dishonest. How close to fraud this is depends on the particular definition their state uses. It doesn't matter if the reason the statement is in the report is because it is a standard form that "everybody" else uses. It was discussed In Chapter 2 that USPAP does not recognize degrees or levels of Ethics. An act is either ethical or it is not. It is not necessary to document the individual cases of appraiser and accountant improprieties. Their existence is well known. This may trigger a concern for the

current and future state of the appraisal profession. Why do appraisers and other professionals behave unethically (dishonestly)?

Certainly, some are just dishonest. These individuals feel that they can best maximize their goals in life by ignoring the rights of others. This is a social disorder, and is beyond the scope of this writing. However, the unethical actions of otherwise ethical individuals are addressed here. The free enterprise system tends to reward companies that are efficient by a mechanism known as the invisible hand (see this discussion in Chapter 1). This principle is illustrated in the following chart.



The trend line demonstrates that as a company's efficiency increases so does its profits. In fact, companies which operate very inefficiently will not reach a level of break-even and will eventually go out of business. As in the example of the Box Makers in Chapter 1, competition will force companies to operate more efficiently. This is good for the consumer as these companies are able to offer like products and services at lower costs. Competition in this simple illustration means ethical business activities. However, as a market of many competing companies reach a higher and higher level of efficiency a limit of improved efficiency is reached. This is based on the principle of diminishing returns. At some point the only way to improve efficiency is by entering into the region of unethical behavior. This is illustrated in the chart below:



Unlike the operation of the *Invisible Hand*, there appears to be no automatic control that prevents companies from entering into unethical behavior and eventually producing goods and services that are ineffective in accomplishing their purpose.

∞Effective Product or service: Is one that will accomplish the task or purpose it was designed for. In appraising this is a credible appraisal.

Some examples of ethical efficiency measures in appraising that do not compromise the effectiveness (credibility) of the appraisal are the use of digital cameras, the electronic delivery of reports, and additional clerical support.

∞Ineffective Product or service: Is one that will not accomplish the task or purpose it was designed to do. In appraising this is an appraisal that is not credible.

Some examples of unethical efficiency measures are: not inspecting the sales from the curb or verifying seller concessions, when the report says that the appraiser did; sending individuals to inventory (inspect) the subject property who are not properly trained, or are not approved by the state appraisal commission; and stating that the supervisory appraiser viewed the subject property from the interior when he/she did not.

There are several reasons that the principle of the *Invisible Hand* tends to continue to pressure companies to seek more profits even to the point the product or service becomes ineffective:

- The rules are ambiguous making it unclear when activities pass from ethical to unethical.
- Enforcement is ineffective.
 - Unethical behavior is not identified, or
 - When discovered is difficult to prove, or
 - The penalties and fines are less than the rewards.
- Inbred Social Instincts.
 - Survival Instinct: The unethical activities of a few can severely negatively affect the financial status of those operating ethically. The more efficient the market is and the more homogenous that the product or service is, the more, and the quicker, this will happen.
 - Fight or Flight Instinct: Humans have a willingness to fight if threatened. In desperate situations desperate actions are often taken.
- Those companies that encourage and benefit from the unethical behavior are often exempt from any punishment.
- Related industries are often successful in lobbying against the implementation of adequate enforcement programs.

This scenario is typical of the free enterprise system and is not just associated with the appraisal profession. There is no need to recite the wave of accounting scandals that have occurred over the past few years such as Enron, Freddie Mac, and Fannie Mae. In Chapter 1 we discussed that Federally Regulated Lenders use collateral products that do not meet the minimum regulations for home equity lines of credit (HELOC). Most of these situations were caused by otherwise ethical individuals who engaged in unethical behavior in order to better compete with companies that had gained an advantage through unethical behavior. This phenomenon infectiously influences all businesses in a specific market. The result is a collective of involuntary unethical behavior. This, if not addressed, will spiral out of control resulting in a breakdown of the free enterprise system for that particular market. The term for this and its definition follows:

∞Collective Involuntary Unethical Behavior (CIUB): The unethical business activities pursued by otherwise ethical individuals that are triggered by survival instincts.

CIUB is an unethical action taken by a business executive in order to neutralize perceived lethal damages from the same unethical action of a competitor. The intent here is not to judge the individuals involved here, that burden is on the legal system and the groups that enforce the various appraisal professional standards. The intent here is to understand the mechanical effect of these forces on human behavior. The resulting behavior of business executives operating in a free enterprise system with insufficient regulation is as predictable as the resulting action of a hammer that is held at shoulder height and is dropped. This is not meant to justify CIUB, but to provide a clear understanding of the environment that many appraisers (and other professions) feel they are forced to contend with.

In reality, there are often layers of unethical behavior in a single business activity. Take for example property flipping; this requires an entrepreneur who pressures a mortgage originator or loan officer to make a loan on a property in excess of its value. The originator/officer then pressures the appraiser to provide an appraisal with an inflated value. If the appraiser complies he will either be acting unethically or incompetently. We will assume he is acting unethically in this situation as incompetence is not a form of CIUB. In the scheme of things, the appraiser's unethical behavior is perceived as more morally wrong by our society than is the unethical behavior of the entrepreneur or the originator/officer. This is because the Professional Appraisal Standards are designed to promote the public trust (see Chapter 2). The entrepreneur is *expected* to try to resell the house as high as the market will allow. The originator/officer is *expected* to push for the maximum loan he/she can make. In this example the originator/officer has crossed the line by coercing the appraiser to provide invalid information to the loan underwriter. The originator/officer has become the architect of the crime (property flipping). This is not to minimize the guilt of the appraiser, but to make the point that the appraiser and the loan officer (as well as the entrepreneur) should share in the resulting penalties.

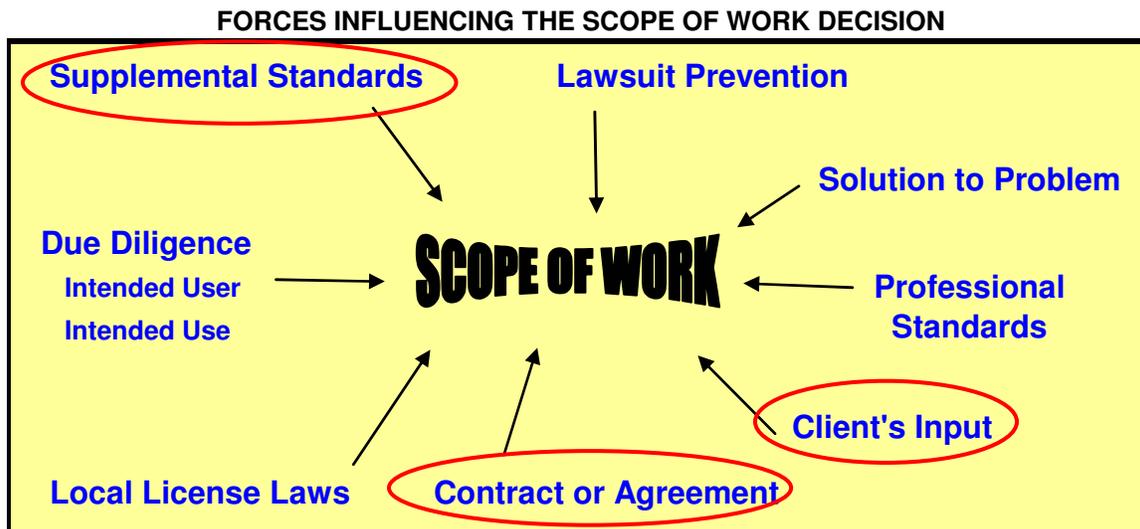
The fact of the matter is that people in a position of public trust are expected to be morally responsible. A judge is expected to act morally and has the authority and protection of the court system. He has the power to hold someone in contempt and to incarcerate them for short periods of time. A policeman is expected to act morally and has the authority and protection of his badge. He has the power to detain or arrest someone who challenges that authority or the authority of the local laws he enforces. The appraiser is provided little authority, therefore little protection. The appraiser's power is something akin to the scene from the Andy Griffith show where Gomer Pyle is yelling "citizen's arrest, citizen's arrest" at Barney. It is well known that someone given the responsibility to carry

out a task must also be given the necessary authority. For example if a supervisor is responsible for the activities of a group of workers, he must also have the authority to discipline that group.

This concept is applicable on a macro as well as a micro level. The State Appraisal Commissions have the responsibility to enforce certain appraisal standards; however, they have found that their authority is limited. This is especially true in regards to applying serious penalties such as revoking an appraiser's license. Certainly, the rights of the individual appraiser should be protected, but the commissions must have the authority to perform the tasks for which they are responsible. On the micro level appraisers licenses give them the authority to perform the tasks for which they are responsible. However, unlike a judge or policeman they have no protection from those that would attempt to compromise their ethics. What authority should commissions and appraisers be given? This topic is beyond this writing, but if these issues are not addressed and corrected the license system, good or bad, will simply become ineffective. In such a state, the system will likely cause more harm to the public that it was designed to protect than if it did not exist. The cancer grows best when the economic activity is brisk and the market place is doing well. This is true for banking, accounting, and the appraisal profession. The conclusion is that industries operating in the free enterprise system must be regulated on a continuous basis. For the free enterprise system to work the laws and regulations put forth by the appropriate agencies must be enforced. Like, excessive regulation, inadequate regulation is counter productive to the overall performance of the economic system.

Enforcement of Professional Appraisal Standards is the first line of defense against CIUB. When that becomes ineffective eventually appraisals will be produced that are not credible. Then the users of appraisals will be forced to seek remedies via lawsuits. A lawsuit can inflict heavy costs to the appraiser such as attorney fees, time away from work, and cash settlements. It is likely that liability management will become the number one consideration of the appraiser when making scope of work decisions in the future. Which do you think a business executive working for a multi-million dollar company is more concerned about when manufacturing inaccurate accounting; their professional standards or going to jail? The best liability program is to always provide credible work product. A proper execution of the Appraisal Planning Process for each individual assignment is imperative to that end.

CHAPTER 4 SUPPLEMENTAL STANDARDS, CONTRACTS & AGREEMENTS, AND CLIENT'S INPUT



This Chapter focuses on the remaining forces that influence the scope of work decision. They are; supplemental standards, contracts and agreements, and input from the client.

SUPPLEMENTAL STANDARDS

Supplemental Standards are defined as “requirements issued by government agencies, government sponsored enterprises, or other entities that establish public policy which add to the purpose, intent and content of the requirements in USPAP, that have a material effect on the development and reporting of assignment results.”²⁰

Supplemental Standards are so important that USPAP has included them as one of the five “Rules”; Ethics, Competency, Departure, Jurisdictional Exception, and Supplemental Standards. This rule states in part that:

“An appraiser and client must ascertain whether any such published supplemental standards in addition to USPAP apply to the assignment being considered.”²¹

The bottom line is that an appraisal is not credible if applicable supplemental standards are not met. An appraisal simply cannot solve the intended user's problem if it cannot be used in the environment in which the problem exists. Consider the following non-appraisal situation:

An investor buys an old house to be converted into an office. An electrician is hired and completes \$8,000 worth of electrical work. However, the work did not meet the City's electrical code. Most of the work will have to be torn out and redone. In this case the electrician did not solve the investor's problem because the work did not meet local codes.

Some of the more common supplemental standards apply to appraisals done subject to FIRREA, Fannie Mae, Freddie Mac, FHA, Federal Government Land Acquisition, estate gift and inheritance taxes, specific courts' laws, etc. Not all guidelines issued by these types of entities constitute supplemental standards because they do not "add" to the requirements of USPAP. Supplemental standards are tightly interwoven with the intended user's problem. In order to produce a credible appraisal, the appraiser must solve the problem in context of applicable supplemental standards.

In Chapter 3 we discussed that when an appraisal is performed there are three possible results:

1. Making the user better off.
2. Making the user neither better nor worse off.
3. Making the user worse off.

If an appraiser provides an appraisal to solve a problem that is subject to supplemental standards, but does not comply with those standards, then result number 1 above will not be reached. The appraisal will either make the intended user worse off or neither better or worse off. Either case voids the possibility of achieving a "credible" appraisal.

Example 1

An appraisal is performed for a loan that will be sold on the secondary market to Fannie Mae. In the course of the appraisal the appraiser inserts his/her own custom limiting conditions and general assumptions. This violates the supplemental standards that Fannie Mae's standard limiting conditions be used. The appraisal is not accepted by Fannie Mae. The solution to the client's problem involved getting the loan underwritten by Fannie Mae. The client's problem was not solved because of the appraiser's lack of understanding of Fannie Mae's supplemental standards.

Example 2

A client was going to court to decide the fair price that the state should pay for a portion of land that had been taken for a new highway. The appraiser formed an

opinion of the market value of that strip of land. However, that judicial system required that the price be decided by subtracting the value of the remainder from the value of the whole. The appraisal was thrown out by the court. The client's problem was certainly not solved. The appraisal was not credible.

How should appraisers approach assignments that are subject to unusual supplemental standards? Appraisers are often asked to accept assignments where the appraisal problem involves unusual court cases, odd estate planning scenarios, etc. In these cases consider requiring that the client's attorney or Certified Public Accountant (CPA) provide written instructions for the appraiser to follow. Emphasis should be on why the instructions are appropriate, which entity has the authority to impose supplemental standards, and identification of any applicable definitions and their sources.

The appraiser must know if there are any supplemental standards that an appraisal will be subject to before the scope of work decision can be made. It is beyond this writing to discuss all of the supplemental standards related to appraising. However, as an example the supplemental standards issued by the Federal Regulatory Agencies are discussed.

Supplemental Standards Issued by the Federal Regulatory Authorities

Many appraisers have a good understanding of Fannie Mae's and Freddie Mac's supplemental standards, but are confused about federal banking regulations. A Federally Regulated Institution (FRI) is one that is regulated by one or more of the Federal Regulatory Authorities.

Let's take a test on these federal regulations! (Answers are provided at the end of Addenda (A).

1. What are the two types of valuations that regulators allow?
2. What is the main (most prominent) test to decide which type of valuation the assignment involves?
3. Which of these types of valuations requires that the appraiser form an opinion of marketing time?
4. Do federal banking regulations require the appraiser to provide a deed with the report?
5. Can an appraisal for a Federally Related Transaction (FRT) be a "limited" appraisal?
6. Is a "restricted use" report format ever acceptable for an assignment involving a federally regulated lender?
7. What is the statement made in the regulations, and used to form some of the regulators' philosophy presented in Addenda (A) that is often incorrect?
8. What limiting conditions and general assumptions do the Regulators require that appraisers use in their reports?
9. How are the regulators' requirements concerning the appraiser's having an interest in the property being appraised different from USPAP's?
10. An appraiser is appraising a group of 10 lots that is a FRT. The appraiser feels the highest and best use would be to list the lots and sell them to individual buyers. The average sales price would be \$50,000 and they would sell out in less than a year. The appraiser forms a final opinion of value of \$500,000. Did the appraiser conform to the supplemental standards associated with a FRT?
11. Can a licensed appraiser accept an assignment that is deemed an evaluation by federal regulators?
12. Can a borrower pay the appraiser directly for an appraisal or evaluation that is ordered by a Federally Regulated Institution (FRI)?
13. Can a regulated institution accept an appraisal prepared by an appraiser who is a family member of the loan broker who engaged him?
14. Can a church be appraised at its value in use for a regulated lender?

If you are an appraiser or reviewer who performs assignments for FRIs and did not have a clue to the answers you may be either acting unethically or incompetently. Many appraisers have attempted to avoid these questions by using a scope of work that encompasses all of the possible supplemental standards. First, this is not possible, and second, the market of appraisal users will not pay the fees associated with these cover-all supplemental standards appraisals. The Appraisal Standards Board (ASB) became aware of the appraiser's ineptness concerning these supplemental Standards a few years ago. In an attempt to solve this dilemma the ASB began communicating with the Federal Regulators on behalf of the profession. Their first effort was the writing

of *Statement on Appraisal Standard No. 10 (SMT-10)*. This is found in USPAP 2005, page 109.

This Statement helped outline some of the appraiser's duties in regards to the work we do for federally regulated lending institutions. However, it became apparent from the appraiser's inability to fully understand this Statement, that appraisers lacked knowledge of some of the basic regulations. This is when the ASB perused the issue further by requesting additional information from the Regulators. This new information was presented in "USPAP Q&A, Vol. 4, No. 9, Questions 1, 2 and 3". This is good stuff! These Q&A's refer to some additional guidelines, "Interagency Appraisal and Evaluation Guidelines", dated October 27, 1994 (guidelines). These guidelines are presented in Addendum A. This information seems to make better sense when these writings are read in reverse order, Addenda (A), the Q&A, and then Statement No. 10. Addenda (A) also includes a very recent writing "Frequently Asked Questions On The Appraisal Regulations And The Interagency Statement On The Independent Appraisal And Evaluation Functions". Both of these letters are interpretations of the Federal Regulations. While not all regulations relating to appraisal standards are included in these letters, many of them are. Other sources of these supplemental standards can be found in the original regulations, and publications and bulletins.

The following framework may be a useful to those planning to read Addenda (A):

- A Federally Regulated Institution (FRI) must consider the information provided in either an "Evaluation" or an "Appraisal" as part of their underwriting process for a loan that is collateralized by real property.
- A Federally Regulated Transaction (FRT) is any real property transaction by a FRI where the regulations require that the appraisal be performed by a licensed/certified appraiser.
- A licensed/certified appraiser is defined in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).
- Typically a licensed/certified appraiser is required for transactions above \$250,000; however, there are some specific exemptions.
- An Evaluation is the minimum standard for all real property loans that are exempt from being a FRT.
- Evaluations may be performed by non-licensed/certified appraisers.
- A licensed appraiser may accept an assignment from a FRI where only an evaluation may be required by regulations, but the scope of work must be expanded to meet USPAP.
- A limited Appraisal may be performed for a FRT, but only if the lender and the appraiser agree that it is appropriate.

The following Table is a partial list of the supplemental standards associated with a Federally Regulated Transaction as presented in the letters of interpretation found in Addenda (A), and various published Regulations:

#	Supplemental Standards	Source
1.	The appraiser should be independent of the loan and collateral functions of the institution and have no interest, direct or indirect, financial or otherwise in the property or transaction. (This is more stringent than USPAP)	Letter 10/27/94
2.	The report must be written and contain sufficient information and analysis to support the institution's decision to engage in the in the transaction.	Letter 10/27/94
3.	The Restricted Use Report format will not be appropriate to underwrite a significant number of transactions. However, it might be appropriate for ongoing collateral monitoring.	Letter 10/27/94
4.	Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.	Letter 10/27/94
5.	Tract Development means a project of five units or more that is constructed or will be constructed as a single development.	FDIC Rules And Regs, §323.2
6.	Include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal.	Letter 10/27/94
7.	For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. The sum of the retail sales for a proposed development is not the market value of the development for the purpose of the Agencies' appraisal regulations.	Letter 10/27/94
8.	For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.	Letter 10/27/94

9.	Each appraisal must contain an opinion of market value.	Letter 10/27/94
10.	The market value opinion must be based upon the definition of market value set forth in the regulation.	Letter 10/27/94
11.	The appraisal must be performed by a State-licensed or certified appraiser in accordance with requirements set forth in the regulation.	Letter 10/27/94
12.	An appraisal fee must be paid by the FRI, not directly from the borrower.	Q&A 3/22/05
13.	Analyze and report data on current revenues, expenses, and vacancies if it is and will continue to be income-producing.	OCC (12 CFR, Part 34) Subpart C, §34.44
14.	Analyze and report a reasonable marketing time for the subject property.	OCC (12 CFR, Part 34) Subpart C, §34.44
15.	Analyze and report on current market conditions and trends that will affect projected income or the absorption period, to the extent they affect the value of the subject property.	OCC (12 CFR, Part 34) Subpart C, §34.44
16.	Include in the certification that, "The appraisal assignment was not based on a requested minimum valuation, a specific valuation, or the approval of a loan."	OCC (12 CFR, Part 34) Subpart C, §34.44
17.	Include a legal description of the subject property, in addition to the description required by USPAP.	OCC (12 CFR, Part 34) Subpart C, §34.44
18.	If information required or deemed pertinent to the completion of an appraisal is unavailable, that fact shall be disclosed and explained in the appraisal.	OCC (12 CFR, Part 34) Subpart C, §34.44
	This is not a complete list of related supplement standards. Readers are encouraged to notify the author of additional standards and their sources for use in future editions.	

The following USPAP directive is very clear in the appraiser's duties concerning supplemental standards:

“Upon agreement to perform an assignment that includes acceptable supplemental standards, an appraiser is obligated to competently satisfy those supplemental standards, as well as applicable USPAP requirements. An appraiser who represents that an assignment is or will be completed in compliance with agreed-upon supplemental standards and then knowingly fails to comply with those supplemental standards violates the ETHICS RULE, or who then inadvertently fails to comply with those supplemental standards violates the COMPETENCY RULE.”²²

The appraiser is responsible to know if any supplemental standards apply to an assignment, and to comply with them. If the appraiser does not know he/she is either acting unethically, or incompetently. When doing appraisals for Federally Regulated Institutions many appraisers rely on the lender to review the appraisal for deficiencies in supplemental standards. Typically the client will note the deficiencies and require the appraiser to correct the deficiency. This system involves a lender (User) who hires an appraiser (expert) to solve the user's problem. It is inappropriate for the expert (appraiser) to rely on the user (lender) to be sure that the appraiser meets the supplemental standards. This is like having a sheep dog to defend the sheep that relies on the sheep to do his job. If the sheep can defend themselves, then there is really no need to have the sheep dog. Appraisers should know as much or more than their clients about the related supplemental standards.

Actually, those appraisal reports that are sent in needing to have revisions are in violation of USPAP. Lenders do not refer most of these deficient reports to the state appraisal commissions. However, in the case of Federal Regulated Institutions bank examiners do have referral procedures. Some of the violations these procedures recognize are found in the following table:

SITUATIONS THAT TYPICALLY RESULT IN A REFERRAL

The appraiser...	Example
"Readdresses an appraisal"	Conceals that the original client was the loan applicant
Accepts a contingent fee	Accepts a fee contingent on the appraisal obtaining a predetermined value
Inaccurately describes improvements	Overstates square footage and number of rooms
Misrepresents the condition of the property	States that the property is in good condition when major repairs are needed
Fails to disclose extraordinary assumptions and hypothetical conditions	Does not disclose that the estimated value depends on obtaining a change in zoning
Presents Faulty Analysis	Uses appraisal methodology applicable for higher valued owner-occupied condos when the property is rental apartment units.
Omits relevant information	Fails to disclose that a number of new office permits have been issued that would adversely affect the absorption of the proposed office building
Includes misleading information	In the case of a property that requires a zoning change, appraiser describes the current political environment as favorable when it is probable that the incumbent zoning officials will be replaced by anti-growth candidates
Includes a series of material technical errors that will affect the credibility of the valuation	Appraisal includes multiple errors such that there is no way to conclude that the valuation is realistic
Fails to follow supplemental appraisal standards contained in the agencies' appraisal regulation	Reports the sum of retail values of units of a tract development project as representing the market value of the whole property.

This information is taken from the article "From the Examiner's Desk... A Focus on the Appraisal Referral Process", Supervisory Insights.²³

Bank examiners are encouraged to refer such violations to their supervisors, who then decide whether or not to send them in to the appropriate state appraisal commission.

CONTRACTS & AGREEMENTS, AND CLIENT'S INPUT

When deciding what tasks will be performed in an appraisal the appraiser must consider any contracts or agreements that he/she has entered into. Contracts and agreements represent requirements for the appraisal assignment. Contracts and agreements differ from supplemental standards as they are imposed by the client and not issued by government agencies, government sponsored enterprises, or entities that establish public policies. These agreements may be found in engagement letters or on the order sheet sent to the appraiser. Contracts and agreements can be associated with any appraisal assignment. Often a bank order will require compliance with that lender's bank policies, or directions in a specific document written by that lender. It is important to have a copy of these documents in the appraisal file. Lenders should make these documents available to the appraiser at the time of the order.

Contracts and agreements may have been exclusively written by the client or result from a dialog between the appraiser and the client. The more knowledgeable the client is the more useful information that he/she will be able to provide to the appraiser. Many appraisers incorrectly believe that the client is neither an appropriate or reliable source of data pertinent to the scope of work decision. Appraisers should consider the data provided by the client, but then consider its reasonableness. It is reasonable to expect that some clients are going to suggest the appraisal be done the way that benefits them the most, which more often than not, will result in a biased appraisal. Can a client manipulate the scope of work to the point that they affect the outcome of the appraisal? Will it be appropriate for the appraiser to form an opinion of value at \$150,000 if the intended use is to get the tax office to lower the property tax, and later conclude \$175,000 for a mortgage loan?

The USPAP does allow for different value opinions when different levels of scope of work are employed by the appraiser. This is based on the fact that an appraiser might have a different value opinion after doing an interior inspection than he/she did based on a curb-side inspection. This would be the case if the interior was either in better or worse condition than assumed in the appraisal based on the curb-side inspection. USPAP does not allow different value opinions solely based on the intended use of the appraisal. **If the same scope of work is employed for different intended uses the opinion of value should be the same.** Nothing in USPAP has changed concerning the requirement for the appraiser to be unbiased. The Ethics Rule found in USPAP edition 2005 states that, "An appraiser must perform assignments with impartiality, objectivity, and independence, and without accommodations of personal interests."²⁴ The appraiser can not ethically reach a "target" value by manipulating the scope of work.

Who should control the scope of work decision, the client or the appraiser? The extent of the client's usefulness is determined by his/her expertise. Most individuals have a very low level of competence in solving real property related problems. In this case the development of the scope of work lies primarily with the appraiser. An exception might be a real estate sales agent who is capable of contributing to the scope of work decision. In the lending arena most lenders are experts in mortgage lending and understand the associated risks. While the appraiser may know more about a specific market and property type he/she knows very little about the terms of the transaction or the business model associated with a large pool of mortgages. In this case the best scope of work decision may result from a team effort. The lender may have an extensive list of required tasks presented in either supplemental standards or policies. This team work scenario is promoted in both USPAP and in supplemental standards.

The Departure Rule found in USPAP Edition 2005 states that a limited appraisal may only be performed when, "...the client has agreed that the performance of a limited appraisal service would be appropriate, given the intended use."²⁵

The Ethics Rule found in USPAP Edition 2005 states that, "An appraiser must perform assignments ethically and competently, in accordance with USPAP and any supplemental standards agreed to by the appraiser in accepting the assignment."²⁶

The following quote is taken from the Guidelines put out by the Federal Regulators dated October 27, 1994 (see Addenda (A)). "An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report."

FANNIE MAE also promotes this team oriented scope of work development on Page 5 of its Document LL07-96 dated September 9, 1996 which states, "If the appraiser's exterior inspection of the property does not provide sufficient information about the subject property to perform the appraisal, he or she must also inspect the interior of the property. Some of the reasons why an appraiser might choose to inspect both the exterior and the interior..."

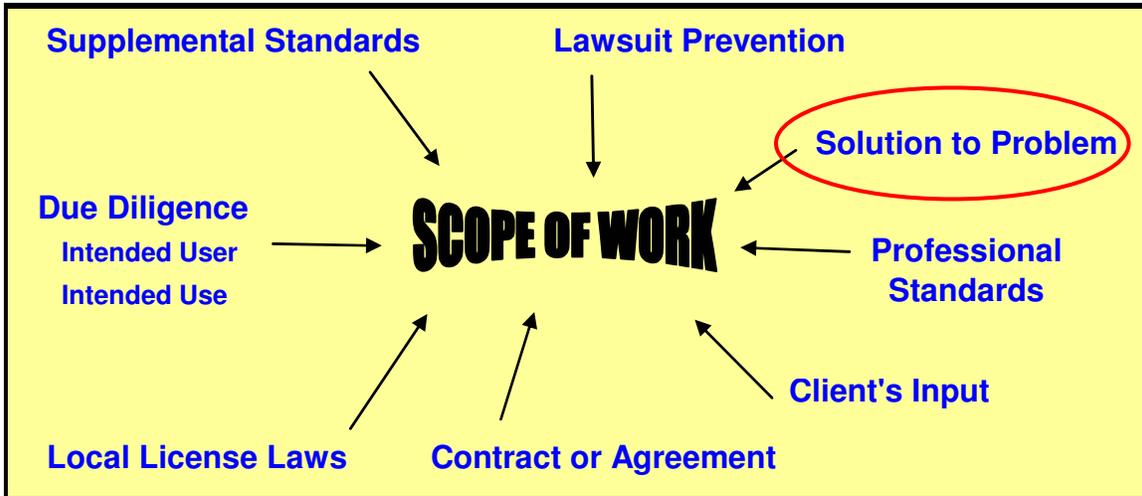
It is clear that USPAP, Federal Regulators, and Fannie Mae require that the scope of work decision be made by both the appraiser and the client for mortgage loans. It is also clear based on the associated dates that this requirement has been around for at least a decade. The consensus is that a credible appraisal will best result from the pooling of knowledge of the appraiser and client. I would agree that in general lenders want to dictate the scope of work. They seem oblivious to the Federal Regulation that was just presented. This is an old problem for appraisers, and not one that will be resolved here.

Appraisers often find themselves in need of the help of the intended user's tax expert when trying to solve a tax related problem. It may be necessary to have input from the intended user's attorney to provide a credible solution to a problem relating to local laws. USPAP still leaves the responsibility of the scope of work decision squarely with the appraiser. Standard Rule 1-2 (f) found in USPAP edition 2005, states that, "An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal."²⁷ This means that your client or intended user may require more scope of work than is necessary, but they cannot require the appraiser to perform less scope of work than is necessary to form a credible appraisal. USPAP continues to say that the final decision of the minimum scope of work is the responsibility of the appraiser.

The appraiser must use the flexibility resulting from the scope of work decision responsibly. An appraiser could not accept an assignment where a loan officer directs that only a curb-side inspection be made because the previous appraiser had made several negative comments about the condition of the interior. This sort of thing is also addressed in the Ethics Rule found in USPAP Edition 2005 under the "Conduct" section, which states that, "An appraiser must not use or communicate a misleading or fraudulent report or knowingly permit an employee or other person to communicate a misleading or fraudulent report."²⁸ Appraisers should be open to any help and guidance that the client or intended users can provide concerning how to best solve their problem.

CHAPTER 5 DIAGNOSING THE PROBLEM AND DETERMINING A SOLUTION

FORCES INFLUENCING THE SCOPE OF WORK DECISION



The steps required to diagnose the problem and develop a solution are listed in Parts I and II of the Appraisal Planning Process (see the following page).

APPRAISAL PLANNING PROCESS

I. Diagnose the Problem

A. Identify the Problem

- 1. Identify the Intended Use**
- 2. Identify the Intended User(s)**
 - a) Recognize the identity/class**
 - b) Recognize if an individual or an entity**
 - c) Determine the level of expertise**
 - d) Determine the risk tolerance**

B. Forces Impacting the Assignment

- 1. Evaluate Assignment Conditions**
 - a) Contracts or Agreements with the Client**
- 2. Recognize applicable bodies of authority**
 - a) Organizations that set Professional Appraisal Standards**
 - b) Organizations that set Supplemental Standards**
 - c) Appraisal Commissions that enforce Laws/Rules other than USPAP**
 - d) Legislatures that make Civil Laws**

II. Develop a solution (Identify Pertinent Information)

- A. Type of Value**
- B. Definition & Source of Value**
- C. Interest (Specific Rights) Appraised**
- D. Effective Date of the opinions and conclusions**
- E. Are any Extraordinary Assumptions Necessary?**
- F. Are any Hypothetical Conditions Necessary?**

DIAGNOSING THE PROBLEM

Many appraisers do the same type of assignment for the same users over and over again. In this situation, each Appraisal Planning Process is just like the last one. In fact, the appraiser may have inherited the scope of work from the appraiser that started him/her in the business, or some other appraiser. In these situations the appraiser may have lost sight of why certain tasks are performed. Some reasons were presented in Chapters 2, 3, and 4. The appraiser seldom thinks of the appraisal as a response to a specific problem often requiring the consideration of supplemental standards. It is hard to imagine that any credible solution to a problem can be determined without a thorough understanding of the problem itself. Yet, in many seminars that I have taught appraisers ask me why they should care what the intended use of the appraisal is? I tell them the following story about the hunter:

Two hunters were walking out in the woods. One of them grabbed at his chest, gasped, turned white and fell to the ground. The other hunter grabbed his cell phone and hurriedly dialed 911. The operator calmly asked, "What is the problem". The hunter replied "My buddy and I are walking in the woods and he grabbed at his chest, gasped, turned white and fell to the ground...I think he is dead... what do I do?" The operator responded in a calm but commanding voice, "Now calm down. The first thing you must do is be sure that he is dead". "OK" the hunter replied. There was a moment of complete silence and then the operator heard a loud shot over the phone. The hunter then asked, "What do I do next?"

Author Unknown

I then ask how they would feel about a plumber that said the problem did not matter as he does the same thing on all service calls. Or, a doctor who says the patient's specific problem is of no concern, as he has a magic pill that works for everything. These examples get a good laugh in class, but I have to wonder how the appraisal profession is viewed by consumers when we profess that our magic pill (URAR form or commercial template) can solve any problem they may have? I believe consumers must view appraisers as absurdly as we see the hunter in the above story. Today's users of appraisals simply do not buy that *can of goods* any longer. I say this both in a figurative and, unfortunately, literal sense as well. The process of diagnosing the problem is equally important to the plumber, doctor, and appraiser in determining the course of action that will be necessary (to solve the problem).

LAYING THE GROUNDWORK

Like the coach who said, "This is a FOOTBALL"; this is an APPRAISAL!

∞Appraisal (Real Property): Providing information that is pertinent to the solution of the stated intended user's problem or predicament. This information relates to the value or marketability of one or more of the bundle of rights of a specific real property. In short, an appraisal contributes to the solution of the intended user's problem.

This definition is of a practical nature while the definition found in USPAP is more of a legal nature. USPAP defines an appraisal as: “(noun) the act or process of developing an opinion of value; an opinion of value. (adjective) or pertaining to appraising and related functions such as appraisal practices or appraisal practices.”²⁹

This definition answers the question as to whether an appraiser’s activities constitute an appraisal. These two definitions do not contradict one another.

Typically, the appraiser provides information pertinent to the intended user’s problem rather than the complete solution.

The purpose of diagnosing the intended user’s problem is to determine;

1. what appraiser-generated primary information is necessary or beneficial,
2. what secondary information will be needed to produce the primary information,
3. the significance of the appraiser-generated information to the solution to the problem,
4. the significance of the problem to the intended user’s welfare, and
5. what other information (not related to value) may be needed.

The first and second sheds light on what analysis the appraiser will need to perform. The third and fourth determine the due diligence (reliability) that the information should have. The fifth is information not related to value, that the appraiser agrees to provide. For clarity let’s add a few more definitions:

∞Appraiser-Generated Information: All primary and secondary information generated in an appraisal.

∞Primary Information: Opinions and conclusions generated in the appraisal that contribute to the solution of the intended user’s problem. This information must be communicated to the intended user(s).

∞Secondary Information: Opinions and conclusions generated in an appraisal that contribute to the assembly (analysis) of the primary information. This information may or may not be communicated to the intended user.

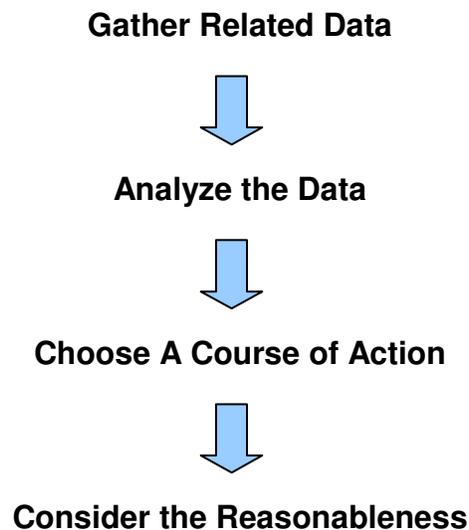
For example, the appraiser’s opinion of the appropriate scope of work for a specific assignment is typically secondary information. An opinion and conclusion can be either primary or secondary information depending on its use. The highest and best use opinion itself is a secondary opinion that is used by the appraiser to form an opinion of the market value. However, in mortgage lending one of the intended user’s questions is “Which loan program should be used to finance the property?” The highest and best use of the property, single-family, apartment, residential vacant land, commercial, etc. will be information necessary

for the intended user to make the decision. This information becomes primary information in the latter case. Identification of the census tract in an appraisal report is an example of “non-appraisal” information.

∞Non-appraisal Information: Non-valuation related Information that the appraiser gathers, but does not personally generate.

The ground work has been laid for beginning the scope of work decision. The appraiser must decide what specific tasks must be performed and the breadth and depth of each task. Most every type of decision is made on a four step process: 1) gathering related data, 2) analyzing the data (forming information), 3) choosing a course of action, and 4) considering the reasonableness of the conclusions. The scope of work decision is no different. The appraiser begins by gathering data that is pertinent to the scope of work decision.

DECISION MAKING PROCESS



GATHERING THE DATA AND INFORMATION NECESSARY

The following data and information will have to be gathered for the appraiser to diagnose the intended user’s problem:

CLIENT- the party or parties who engage an appraiser (by employment or contract) in a specific assignment.³⁰ (USPAP 2005)

INTENDED USER- the client and any other party as identified, by name or type, as users of the appraisal, appraisal review, or appraisal consultant report by the

appraiser on the basis of communication with the client at the time of the assignment.³¹ (USPAP 2005)

Some characteristics of an intended user:

- Identity/Class
- Individual or entity
- Risk tolerance
- Level of competency

The appraiser must consider the user's tolerance to risk. Is the intended user an elderly person of modest means where their property represents their primary wealth? Or, is this property a part of a large pool of mortgage loans where a loss could easily be absorbed?

What is the user's level of competency? Is the user a first time buyer? Or is the user a real estate sales agent who owns numerous rental properties. If the user is an expert in mortgage loans such as FANNIE MAE or FREDDIE MAC the appraiser may assume that their guidelines sufficiently screen them from exposure to excessive risk. These entities should know their risk tolerance better than anyone else. However, they may not be fully aware of the amount of risk associated with each individual property. Experts often know their risk tolerance, and convey them to the appraiser in supplemental standards. The appraiser should have a feel for this acceptable risk and develop a scope of work that is appropriate. The appraiser should not forget that should these entities become insolvent, the general public could be hurt. The appraiser can delegate authority to a point, but he/she can never delegate the responsibility of performing the appropriate scope of work, even for a knowledgeable intended user.

INTENDED USE: the use or uses of an appraiser's reported appraisal, appraisal review, or appraisal consulting assignment opinions and conclusions, as identified by the appraiser based on communication with the client at the time of the assignment.³² (USPAP 2005)

∞Intended User's Problem: A dilemma concerning real property that requires choosing a course of action among multiple possibilities.

∞Pertinent Information: Information relating to the real property that will aid the intended user in solving his/her problem.

∞Information (Appraising): Opinions and conclusions that were formed by executing the tasks specified, and in the manner specified by the scope of work decision. This information can be assessed in terms of type, amount, and reliability.

∞Cost Effective: When the benefits of the valuation service derived by the intended user exceeds the associated costs of obtaining that service.

In light of these definitions, the Appraisal Planning Process begins to open the door to an understanding of what constitutes a “credible” appraisal.

∞Credible (Appraising): When the pertinent information in an appraisal meets or exceeds the practical demands of the problem being solved or decision being made for a particular class of intended users.

DEVELOPING A SOLUTION

Most appraisers will be able to accomplish these above tasks intuitively, much like riding a bicycle. However, for illustrative purposes these steps are isolated and executed individually in the following case studies.

Case studies 1-4 are for the same residential property, but are valued at different times for different reasons.

CASE STUDY 1

On January 12, 2002, Mary Smith, an appraiser, received a visit from Mike Brown, a bank loan officer with Home Town Bank. Home Town Bank is a Federally Regulated Institution. Mary has been doing business with the bank for several years. Mike has always been honest and fair in his dealings with Mary. Mike said that the bank implemented a new policy mandating that loan officers minimize the appraisal fees charged to the borrowers by ordering the (minimum) appropriate scope of work for each appraisal. Mike said that he did not need any flood hazard information, but did need the census tract number for all real property loans. He also said that he would need the appraisal by next Tuesday.

Mike explains that his current deal involves a \$30,000 first mortgage, and he can loan on an 80% loan to value ratio. Mike had a copy of the tax card which shows an estimate of value of \$200,000 (Land \$50,000 and Improvements \$150,000). Mary has worked that subdivision many times and knew that the tax assessor's estimate of value was typical of the area. Mike also provides a photo of the front of the property which he recently took.

Mike explains that the borrower has been banking with them for many years and has an excellent credit rating. The purpose of the loan is so he can send his granddaughter to college. Mike knows that the borrower has numerous holdings, including a \$100,000 CD at the bank, but all would require a significant penalty for early withdrawal.

Diagnose the problem:

- The intended use is to provide information related to the underwriting of a very low risk mortgage loan.
- The intended user is the Home Town Bank. The intended user is both experienced and knowledgeable in the field of mortgage lending. The loan is part of a pool of loans and the portfolio manager has allowed for a loss rate.
- Recognize Forces Impacting the Assignment:
 - Agreements/Contracts: To provide a census tract number and deliver the report by next Tuesday.
 - Appraisal Standards: USPAP will have to be followed.
Supplemental Standards: The supplemental standards associated with an "Evaluation" as defined by the Regulatory Agencies.
 - Appraisal Commission's Laws/Rules: None presented in the example.
 - Local Civil Laws: There are no specific laws that influence the scope of work, however, some warnings will be put into the report to make it very clear that the appraisal is limited in scope of work, that no third party's interests were considered, and that the appraisal report must only be used for the stated intended use.

Determine a solution (Determine the primary information pertinent to the solution of the intended user's problem).

- Type of Value: Market Value
- Value Definition: Federal Regulatory Agency's definition
- Source of Definition: OCC [12 CFR, Part 34, Subpart C-Appraisals, §34.42 Definitions (f)]
- Interest Appraised: Fee Simple
- Date of the Value Opinion: Current- date of the inspection.
- Extraordinary Assumptions: If a visual inventory is not made a related extraordinary assumption will need to be stated.
- Hypothetical Condition: None necessary

Appraiser Generated Primary Information: An opinion of market value; the highest and best use, and exposure time. The highest & best use will help the underwriter determine which loan program is appropriate for the property.

CASE STUDY 2

On April 2, 2002, Mary Smith, an appraiser, received a call from Mike Brown, a bank loan officer with whom she has been doing business for several years. Mike has always been honest and fair in her dealings with Mary. Mike said that the bank has implemented a new policy mandating that loan officers minimize the appraisal fees charged to the borrowers by ordering the (minimum) appropriate scope of work for each appraisal.

It is a \$125,000 first mortgage. Mary pulled a copy of the tax card which shows an estimate of value of \$200,000 (Land \$50,000 and Improvements \$150,000). Mary has worked that subdivision many times and knew that the tax assessor's estimate of value was typical of the area. Mike explains that the borrower has been banking with them for many years and has an excellent credit rating. Mike explains that this loan will be kept in the bank's portfolio. Mike requested Mary to do a drive-by as the borrowers were out of town until next week.

Diagnose the problem:

- The intended use is to provide information related to the underwriting of a low risk mortgage loan.
- The intended user is the Home Town Bank. The intended user is both experienced and knowledgeable in the field of mortgage lending. The loan is part of a pool of loans and the portfolio manager has allowed for a loss rate.
- Recognize Forces Impacting the Assignment:
 - Agreements/Contracts: To provide a census tract number and to meet USPAP.
 - Appraisal Standards: USPAP will have to be followed.
Supplemental Standards: The supplemental standards associated with an "Evaluation" as defined by the Regulatory Agencies.
 - Appraisal Commission's Laws/Rules: None presented in the example.
 - Local Civil Laws: There are no specific laws that influence the scope of work, however, some warnings will be put into the report to make it very clear that the appraisal is limited in scope of work, that no third party's interests were considered, and that the appraisal report must only be used for the stated intended use.

Determine a solution (Determine the primary information pertinent to the solution of the intended user's problem).

- Type of Value: Market Value
- Value Definition: Federal Regulatory Agency's definition
- Source of Definition: OCC [12 CFR, Part 34, Subpart C-Appraisals, §34.42 Definitions (f)]
- Interest Appraised: Fee Simple

- Date of the Value Opinion: Current- date of the inspection.
- Extraordinary Assumptions: If an interior inventory is not visually made a related extraordinary assumption will need to be stated.
- Hypothetical Condition: None necessary

Appraiser Generated Primary Information: An opinion of market value, the highest and best use, and exposure time.

CASE STUDY 3

On September 12, 2002, Mary Smith, an appraiser, received a call from a mortgage broker. The broker requested her to do a traditional Fannie Mae secondary market appraisal on the URAR form. This loan program allows up to an 80% loan to value ratio.

Based on preliminary market data gathering, Mary felt the property was in the \$225,000 range. The home was 30 years old. The owners said that they planned to totally redo the interior, as soon as their granddaughter finished at Harvard Law School. In fact, they had two bids on the work to be done. They were both at about \$50,000.

Diagnose the problem:

- The intended use is to provide information related to the underwriting of a mortgage loan.
- The intended user FANNIE MAE and other secondary market participants. The intended user is both vastly experienced and knowledgeable in the field of mortgage lending. The loan is part of a pool of loans and the portfolio manager has allowed for a loss rate.
- Recognize Forces Impacting the Assignment:
 - Agreements/Contracts: To provide all information requested on the appraisal form, and to meet USPAP.
 - Appraisal Standards: USPAP will have to be followed.
Supplemental Standards: The supplemental standards associated with FANNIE MAE for the URAR form.
 - Appraisal Commission's Laws/Rules: None presented in the example.
 - Local Civil Laws: There are no specific laws that influence the scope of work; however, some warnings will be put into the report to make it very clear that the appraisal is in scope of work, that no third party's interests were considered, and that the appraisal report must only be used for the stated intended use.

Determine a solution (Determine the primary information pertinent to the solution of the intended user's problem).

- Type of Value: Market Value
- Value Definition: As per FANNIE MAE.
- Source of Definition: FANNIE MAE FORM 1004B.
- Interest Appraised: Fee Simple
- Date of the Value Opinion: Current- date of the inspection.
- Extraordinary Assumptions: Non necessary.
- Hypothetical Condition: None necessary.

Appraiser Generated Primary Information: An opinion of market value, the highest and best use, exposure time, and marketing time.

CASE STUDY 4

On December 15, 2002, Mary Smith, an appraiser, received a call from Mary and Rod Graham. They are considering purchasing the property, and wanted a pre-contract appraisal on their behalf. They wanted to be sure they were not paying too much for the property. They got Mary's name and number from the phone book under the "Real Property Appraiser" listings.

Based on preliminary market data gathering, Mary felt the property was in the \$175,000 range. She considered this to be a situation where her opinion of value would have to be as reliable as possible. The buyers were not represented by a real estate sales person, nor were they especially knowledgeable concerning real estate.

Diagnose the problem:

- The intended use is to provide information for the intended users to formulate a purchase decision.
- The intended user Mary and Rod Graham
- Recognize Forces Impacting the Assignment:
 - Agreements/Contracts: None
 - Appraisal Standards: USPAP will have to be followed.
Supplemental Standards: There are no supplemental standards associated with this assignment.
 - Appraisal Commission's Laws/Rules: None presented in the example.
 - Local Civil Laws: There are no specific laws mentioned in the example.

Determine a solution (Determine the primary information pertinent to the solution of the intended user's problem).

- Type of Value: Market Value
- Value Definition: Any definition that is reasonable. The Federal Regulatory Agency's definition is used.
- Source of Definition: OCC [12 CFR, Part 34, Subpart C-Appraisals, §34.42 Definitions (f)]
- Interest Appraised: Fee Simple
- Date of the Value Opinion: Current- date of the inspection.
- Extraordinary Assumptions: None necessary except any related to limitations on the property inspection.
- Hypothetical Condition: None necessary

Appraiser Generated Primary Information: An opinion of market value, the highest and best use, and exposure time.

These Case Studies demonstrate a wide variety of assignments. In the next Chapter the due diligence associated with the assignment will be considered for each of the four Case Studies.

HYPOTHETICAL CONDITION:

In order to solve a problem the appraiser must often use a hypothetical condition. This is something the appraiser knows not to be true. A partial taking in eminent domain is an example of this. The appraiser must use the hypothetical condition that the proposed taking is not available for use by the remaining property in order to assess the effect it has on the value. There must always be sound reasons for using a hypothetical condition, as its use creates potential for misuse of the appraisal.

EXTRAORDINARY ASSUMPTION:

An Extraordinary Assumption involves assuming as true something which may or may not be true, the outcome of which may have an effect on the valuation. Often the problem to be solved requires immediate action by the intended user. This requires the appraiser to provide information and conclusions prior to complete verification of certain facts. An example of this is a possible foreclosure where no interior inspection is possible. The lender must decide what action to take before it takes possession of the property. The appraiser may have to provide information and conclusions without an interior property inspection. The appraiser should believe the assumption is reasonable and probably true, and that the user must act prior to verification. There must always be sound reasons for using an extraordinary assumption, as its use creates potential for misuse of the appraisal.

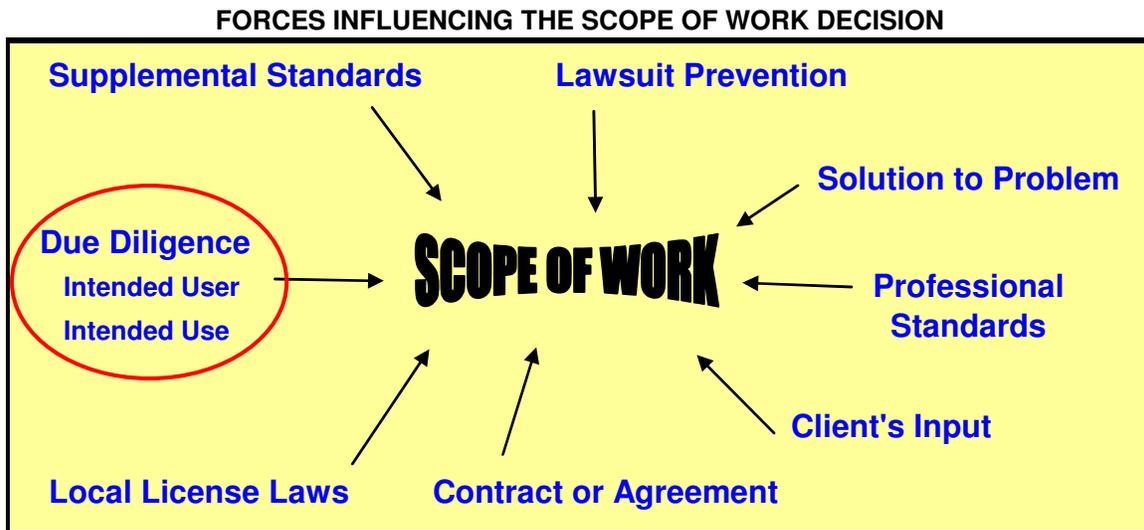
A hypothetical condition or an extraordinary assumption should only be used when they are necessary to solve the intended user's problem. Appraisers often inappropriately attempt to use these tools for liability management. The attempt to *hypo* or *assume* away the complicating factors in an appraisal result in an appraisal that is not credible.

Example of Improper Use: A court system needs an appraisal of a single-family property so that it can set the price that one spouse will have to pay to buyout the other. The appraiser finds a significant amount of water flowing through the crawl space.

1. He/she uses a hypothetical condition that there is no water to avoid the issue.
2. He/she uses an extraordinary assumption that the water poses no serious problem.

Both of these situations result in misleading appraisals. The only way that the appraiser can provide useful information to the judge is to get to the bottom of the problem. Studies as to the source and correction of the water problem should be ordered. An inspection for water related problems such as mold should be made. Only at this point should the appraiser complete the assignment.

CHAPTER 6 DUE DILIGENCE



The expectations of life depend upon diligence: The mechanic that would perfect his work must first sharpen his tools.

Confucius

DUE DILIGENCE

Chapters 2, 3, and 4 focused on some of the forces that drive the scope of work in an appraisal assignment. The complexity of the scope of work decision is simplified by analysis of its subparts. This Chapter is a continuation of the dissection of the scope of work decision. It considers one of the subparts; *Due Diligence*. The concept of due diligence is at the heart of the scope of work decision.

In Chapter 3 the importance of “Public Trust” was discussed. One of the goals of the appraisal profession is for the public to trust that the appraiser will act responsibly. It is the appraiser’s responsibility to produce a credible appraisal. A credible appraisal is achieved when the pertinent information in an appraisal meets or exceeds the practical demands of the problem being solved or decision being made for a particular class of intended users (see Chapter 5). How much work the appraiser does is the scope of work (chapter 7). But what is meant by the appraiser’s Due Diligence?

The appraiser's due diligence is measured by the seriousness of the problem to the intended user. The more negatively the intended user's decision (choice) can affect him/her, the more due diligence is required in the preparation of the appraisal. The relationship between the due diligence and the scope of work performed in an appraisal is much like the relationship between diet and dietary needs. The due diligence is like dietary needs, while the scope of work is like the diet (types and amounts of foods eaten). Just as the dietary needs of different types of animals vary, so does the due diligence requirement for different types of assignments. And, just as the dietary needs of individual animals within the same type can differ, so can the due diligence requirement for intended users within the same type of assignment. It would be inappropriate to feed all animals the same types and amounts of food. It would also be inappropriate to choose the amounts and types of food to feed an animal before its dietary needs were known. The remainder of this Chapter is devoted to determining the due diligence requirements of a particular assignment.

ASSESSING THE DUE DILIGENCE

Due Diligence: "Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by an absolute standard, but depending on the relative facts of the special case."³³ (Black's Legal Dictionary)

∞Due Diligence (Appraising): The degree of care, prudence, and meticulousness required in the preparation of an appraisal.

∞Due Diligence Decision: A process in which an opinion is formed as to the appropriate due diligence for a particular appraisal assignment.

Because the concept of due diligence as an individual step in performing the scope of work decision is new to the appraisal profession some type of language must be devised that will communicate it in terms of measurement. The language of statistics is very functional for discussing the due diligence (and scope of work) in the context of appraising. Although the examples are presented with specific numeric measurements, in reality the concept of due diligence has not reached that level of sophistication in the day to day work of the appraiser. It is the intent of this writing to enable the appraiser to conceptualize how the risk associated with the assignment affects the intended user, and in general how the scope of work affects the reliability of the appraisal.

The first difficult concept is the accuracy associated with a value opinion. The appraisal profession has generally stayed away from the term accuracy. Generally, value is considered to be a monetary relationship between buyers and sellers, and as such is never a fact.³⁴ How can the accuracy of an archer's shot

be measured if each judge has a different opinion of where the bulls-eye is located on the target? Consider that the accuracy of the value opinion is a measure of the difference in the appraiser's opinion and the actual market behavior. Some of the characteristics of a market are its activity and its efficiency.

∞Market Risk: The inherent inconsistent behavior of buyers and sellers within a market that is not affected by the scope of work in an appraisal.

∞Possible Market Risk:

If a market typically varies 10% and the value of a property is \$100,000 then the range would be \$10,000 ($\$100,000 \times 10\%$), a range of values from \$95,000 to \$105,000 would result.

(For simplicity and demonstration this calculation is based on an equal distribution and is measured from the center of the spread.)

∞Likely Market Risk:

If the appraiser's opinion of value is in the middle of this range then the market risk is one-half of the *possible variance* or 5% ($10\% \times 0.5$). The more efficient the market operates the less variance in behavior.

In the example above the possible market risk is 10%, while the likely market risk is 5%.

Consider Market 1 which is an urban area with blocks and blocks of similar style, quality, and age properties. There are a number of knowledgeable sales agents that use a multiple listing service (MLS). The economy is very stable in the area and the general population is savvy about real estate and its value.

Market 2 on the other hand, is a very rural area with a mix of property styles, qualities, and ages. There are only a few sales agents who are not particularly knowledgeable, and they do not have an MLS. The sales agents feel the less the buyers, sellers, and especially their competitors know about the market the more secure they are.

In Market 1 it is likely that if the same property were sold 10 times the sale prices might all be within a 5% range of each other. On the other hand, if the same property sold 10 times in Market 2 the sale prices might be within a range as large as 20%. The appraisal can never be more accurate than the market risk associated with the subject property's market, as market risk and appraisal risk are mutually exclusive of each other.

∞Appraisal Risk: the variance in the value opinion from the actual market value that is a function of the scope of work in the appraisal. It does not include the *Market Risk*.

∞ Absolute User Risk: Market Risk + Appraisal Risk

The flip side of absolute user risk is absolute user reliability.

∞ Absolute User Reliability: The overall or total reliability of the opinions and conclusions formed in an appraisal. In other words one minus the sum of Market Risk and Appraisal Risk:

$\text{Absolute User Reliability} = 1 \text{ less } (\text{Market Risk} + \text{Appraisal Risk})$

The concept of absolute user reliability of an appraiser's value opinion is typically understood by the providers and users of appraisals. However, the definitions of "Due Diligence" presented earlier in this chapter do not mention the term absolute reliability. Due diligence is more concerned with the relationship of the absolute reliability and the needs of the intended user.

Determining the effect of Appraisal Risk on Intended User's Welfare

Use of these terms will make the due diligence decision easier to understand. The due diligence decision is an opinion of the absolute reliability that is appropriate for the intended user for the intended use. The question is; what effect will the absolute reliability have on the intended user's welfare? The following things must be considered in order to perform the due diligence decision:

1. The significance of the pertinent information to the intended user's problem.
2. The effect of the appraisal risk on the intended user's position.
3. The intended user's risk tolerance, and
4. The amount of market risk

1. The significance of the pertinent information to the intended user's problem

The information (conclusions and opinions) provided to the intended user typically does not represent all of the information that the intended user will base his/her decision on. For example, when making a mortgage loan the lender considers the value of the subject property, but also considers the borrower's willingness and ability to repay the loan. Often a lender will take the subject property and some other real property as collateral for the loan. This extra property is considered an "abundance of caution" and as such is not heavily relied on in the decision making process. On the other hand, if a potential purchaser is trying to make a decision on how much to pay for a property, the information provided in the appraisal may be the only information considered. As a general rule, the more the intended user relies on the appraiser-generated information, the more due diligence that is required of the appraiser.

2. The effect of the appraisal risk on the intended user's position

This is the most complex of the things that influence the due diligence decision. It considers the use of the appraisal by the intended user and the ramifications to the intended user by examining the parameters of the problem. Consider the following situations:

Situation 1: A lender is making a first mortgage of \$50,000 that has a 50% loan to value ratio. The market variance is about 10%, which means that if the value opinion is in the middle of this range then the best the appraiser can do is be within 5% of the actual market value (\$95,000 to \$105,000). The lender is operating on an 80% loan to value ratio requirement so, the lender's question is, "Is the property worth at least \$80,000 ($\$100,000 \times 80\%$)"? The loan to value ratio is the lender's statement of his risk tolerance, which in this case is 20%. The allowable appraiser risk (error) is then 15% (Risk Tolerance – Market Risk). What is the effect of the appraisal risk on the intended user? The appraiser can be \$15,000 ($\$100,000 \times 15\%$) too low before the intended user could lose any money. The total amount of money that the intended user can lose represents his "exposure". In this situation the intended user's exposure is \$50,000. This information will later help in determining the appropriate scope of work for the assignment (*Question: If omission of a certain task reduces the absolute reliability of the value opinion by 5%, saves \$50 on the fee, and decreases the delivery time by one-half a day could the task be omitted?*)

Situation 2: An appraisal is being made so the intended user can make a declaration of how much capital gains tax should be paid to the IRS. The tax accountant has determined that the intended user should pay a 20% capital gains tax. There is a 20% penalty associated with under-paying the tax. So, if the appraisal is over-valued by \$10,000 then the intended user would pay \$2,000 extra in taxes ($\$10,000 \times 20\%$). If the property is under-valued by \$10,000 then the intended user could pay \$2,000 in penalties ($\$10,000 \times 20\%$). In either case, the ratio of the Intended user's loss to appraiser error is 1:5.

Situation 3: An appraisal has been ordered for the division of an estate. One sibling is buying the deceased parent's home. Both siblings are intended users of the appraisal report. They believe the property to be worth about \$100,000 but feel they should get an appraisal. What is the effect of appraisal risk (error) on the intended users? If the appraiser is \$10,000 too high or too low then one of the intended users will benefit \$10,000 and the other will be hurt by \$10,000. Basically, the intended user(s) will be hurt on a dollar for dollar basis of the appraiser's error. This is a 1:1 ratio of appraisal error to the loss to the intended user. In this situation, the due diligence requirement is very high as the net affect (benefits less cost) of an intense scope of work enhances the intended user(s) position.

In the over-all picture the primary influence on the due diligence of the appraiser is the effect that varying appraisal risk will have on the intended user's position.

In each example the parameters of the intended user’s problem are considered to determine the effect of the appraisal risk on the intended user. These examples show when the intended user starts to lose money, and how much money can be lost, are important issues in the due diligence decision. In general, the higher the ratio of appraisal error to the loss to the intended user, the more due diligence is associated with (required for) the assignment.

3. The intended user’s risk tolerance

The due diligence decision must consider the risk tolerance of the intended user. Is the intended user a young couple where their property represents a large part of their wealth, or is the intended user a real estate investment trust (REIT) where the property is one of thousands in a well managed portfolio? In general, the lower the intended user’s risk tolerance is, the more due diligence is associated with the assignment.

As discussed earlier in this Chapter the appropriate due diligence (and scope of work) cannot really be expressed in quantitative percent variations such as plus or minus 15%. However, the appropriate due diligence can be expressed in qualitative categories such as; “Minimal”, “Low”, “Moderate”, and “High”.

The remainder of this Chapter focuses on categorizing the due diligence requirements for the Case Studies presented in Chapter 5.

Case Study	Significance of information to problem	Appraisal error to Intended user	Market Risk	Intended User’s Risk Tolerance	Due Diligence
One	Moderate	Minimal	Unknown	Moderate	Minimal
Two	Moderate	Low	Unknown	Moderate	Low
Three	Moderate	Moderate	Unknown	Moderate	Moderate
Four	High	High	Unknown	Low	High

The scope of work should be customized for a particular use and user. The general rule is that the more intended uses and users identified in the appraisal the more intense the scope of work should be. If the intended uses and users are not clearly identified then the appraiser’s nightmare begins. USPAP is clear about this issue:

“It is essential that an appraiser establish with the client a clear and mutual understanding of the needs of all intended users prior to accepting the assignment.”³⁵

“When a client intends that a report be used by others, the needs of those additional users may affect the extent of the appraisal, appraisal review, or appraisal consulting process as well as the content of a report.”³⁶

4. The amount of market risk

The amount of the market risk must be considered when the intended user's allowable risk tolerance is expressed in absolute variance (market risk + appraisal risk). It stands to reason that the appraiser will have to work harder to achieve the same absolute reliability in an inefficient market as in a market that operates very efficiently. In general, the higher the market risk, the more due diligence is associated with the assignment.

Other Gauges of the Due Diligence

The due diligence decision is so important that the appraiser should consider any input from knowledgeable clients, applicable bodies of authority, appraisal peers, factored with the expectations of the typical users. This input does not include specific scope of work requirements for the appraisal from these parties. Specific requirements are a built-in part of the scope of work decision regardless of the due diligence associated with the assignment. However, if any of these parties is especially knowledgeable concerning the due diligence then their input may be very helpful to the appraiser.

CHAPTER 7 THE SCOPE OF WORK

A developer is planning a subdivision development of 200 acres. Upon completion the development will consist of building lots for detached single-family homes. A bridge will have to be built over a large stream that runs year around. The engineer's task is to design a suitable bridge and develop the appropriate building specifications. In order to make this decision the engineer needs the following information:

- The maximum height and width of the stream;
- the number of lanes needed for the expected traffic;
- the maximum load that will be on the bridge at one time; and
- any applicable building codes.

This situation is a good analogy of what the appraiser does when performing the scope of work decision (Chapter 8), which is similar to an engineer's development of the specifications for a bridge. The goal of the engineers is to produce specifications for the bridge that will enable the bridge to meet the practical demands that it will be exposed to, at a reasonable cost to build. In the development of the specifications of a bridge, the engineers must be aware of:

- Construction Techniques:
 - which will be necessary;
 - the level of competency required for the various techniques; and
 - the effect that each type of technique will have on the strength (function) of the bridge.
- Building Materials:
 - what materials are available;
 - the characteristics of these materials;
 - what their current costs are; and
 - how the various combination of materials will affect the strength and functionality of the bridge.

Scope of Work: "the amount and type of information researched and the analysis applied in an assignment. Scope of work includes, but is not limited to, the following:

- the degree to which the property is inspected or identified;
- the extent of research into physical or economic factors that could affect the property;
- the extent of data research; and

- the type and extent of analysis applied to arrive at opinions and conclusions.”³⁷ (USPAP 2005)

The term *scope of work* may be used in various ways:

1. The Scope of Work Plan (The result of the SOW Decision).
2. The Scope of Work Performed (What was actually done).
3. The Appropriate Scope of Work (What should have been done).

The reliability of the pertinent appraiser-generated information is a direct function of the “depth and breadth” of the data gathering process and the “depth and breadth” of the analysis. For example, it is reasonable to expect that an appraisal performed with the appraiser accessing the interior and exterior of the property will be more reliable than an appraisal prepared with the appraiser only viewing the property from the curb. The competency level of the data gatherer and of the analyst is also important components of the scope of work. This Chapter discusses how varying the scope of work will affect the reliability and the cost of the appraisal.

The cost includes both the appraisal fee and the time associated with the user receiving the appraisal. The cost related to time is the cost to the intended user caused by the delay in making the decision that would not have been incurred without the appraisal. This means that if it takes two days to prepare the paper work to close a loan and it takes four days to obtain and comprehend the appraisal then the *appraisal time delay* is two days (not four days). This is why it is important for the appraiser to know the earliest that the lender could close the loan not considering the appraisal. What sort of tangible costs could result to the lender during this two day delay? The worst case scenario is that the borrower has extra time to shop interest rates and might simply walk away from the first lender. In this case the lender loses revenues, but more importantly has wasted several hours originating and processing the loan. Another cost to the lender is potential cross-sales of other bank services. Is it any wonder that lenders want to close ASAP? In our office we joke that the best designation letters an appraiser can have are “PDQ”.

Lenders are not the only class of clients that needs quick turn-times. An individual who requests a pre-closing appraisal and property inspection could be faced with losing a low interest rate lock. A half of a percentage point over the life of a 30 year loan could be significant. There are more examples than we have time here to consider. The point is that the appraiser must be aware of the costs to the intended user associated with any time delay caused by the appraisal, as the intended users certainly are. If the appraiser is making a scope of work decision (designing the appraisal) and he/she is deciding which of two tasks to omit and they both will add the same amount of reliability to the appraisal and cost the same on an hourly basis then the one that will take the longest to complete should be omitted.

∞Appraisal Time Delay: The delay experienced by the intended user in making the decision that prompted the appraisal that would not have been incurred without the appraisal.

∞Time Delay Cost to the Intended User: The tangible and intangible costs occurring to the intended user as a direct result of the *Appraisal Time Delay*.

IMPLICATIONS OF VARYING THE SCOPE OF WORK

Like in Chapter 6, some of the examples are presented with specific reliability measurements such as plus or minus 10%. However, this is for illustrative purposes only. The goal here is for the appraiser to gain a general feel of how varying the scope of work will have on the reliability of the appraisal. Once the appraiser has identified the due diligence requirement and understands how the scope of work affects the appraisal risk, he/she will be prepared to execute the scope of work decision (bid the appraisal appropriately).

Once the appraiser has formed an opinion of the Due Diligence requirements of an assignment the next task is to engineer the scope of work (design the bridge) that will result in a credible appraisal. This involves understanding how the amount of work performed in an appraisal affects the absolute reliability of that appraisal. In Chapter One the legitimate use of appraisals based on varying degrees of the scope of work was presented. The scope of work decision allows appraisers great flexibility. This flexibility can be used ethically or as a tool to manipulate the appraisal's opinions and conclusions. Unscrupulous clients may purposely order appraisals that are so circumscribed (limited) in scope of work as to not be credible. An example is a loan officer that orders a drive-by appraisal because the previous appraisal identified interior deficiencies. Often, the loan officer asks this of the same appraiser that performed the first appraisal! Let's take a second and discuss the ethics of such a practice. It is unethical! The second is over. It is necessary for reviewers and appraisal enforcement agencies to understand how varying the scope of work can affect the value opinion of a property. An understanding of the relationship of intended use, scope of work, and absolute reliability will allow the reviewer to determine if the information generated by the appraisal is in fact credible.

It is quite appropriate for a client to order a series of appraisals with increasing levels of scope of work for a property in search of a target number, but this target may not be pursued by decreasing the level of the scope of work.

Consider the four situations presented on the following pages. They are titled as Desktop, Drive-by, URAR Traditional, and Purchase Decision. These examples

demonstrate how the reliability of an appraisal might be affected by varying the scope of work:

DESKTOP ONLY

On January 12, 2002, Mary Smith, an appraiser, received a visit from Mike Brown, a bank loan officer with whom she has been doing business for several years. Mike has always been honest and fair in his dealings with Mary. Mike said that the bank has implemented a new policy mandating that loan officers minimize the appraisal fees charged to the borrowers by ordering the (minimum) appropriate scope of work for each appraisal.

Mike explains that his current deal involves a \$30,000 first mortgage, and he can loan on an 80% loan to value ratio. Mike had a copy of the tax card which shows an estimate of value of \$200,000 (Land \$50,000 and Improvements \$150,000). Mike also provides a photo of the front of the property which he recently took.

Mike knows this is a low risk transaction because the borrower has been banking with him for many years and has an excellent credit rating.

Mary has worked that subdivision many times and knew that the tax assessor's estimate of value was typical of the area. Further, it is not unusual for the lots to sell in the \$50,000 range. Based on the tax card and the photo, she researched some sales and did a quick qualitative analysis. She entered the information into the computer and printed out a report that stated the value as "Greater than \$40,000". She showed Mike her file memoranda that indicated a \$200,000 opinion of value with a qualifier of a 45% range of accuracy. This means that the true value is anywhere from \$110,000 to \$290,000. This is a wide spread, but certainly shows that it is safe for Mike to make a \$30,000 first mortgage.

DRIVE-BY

On April 2, 2002, Mary Smith, an appraiser, received a call from Mike Brown, a bank loan officer with whom she has been doing business for several years. Mike has always been honest and fair in his dealings with Mary. Mike said that the bank has implemented a new policy mandating that loan officers minimize the appraisal fees charged to the borrowers by ordering the (minimum) appropriate scope of work for each appraisal.

It is a \$125,000 first mortgage. Mary pulled a copy of the tax card which shows an estimate of value of \$200,000 (Land \$50,000 and Improvements \$150,000). Mike explains that the borrower has been banking with them for many years and has an excellent credit rating. Mike explains that this loan will be kept in the bank's portfolio. Mike requested Mary to do a drive-by as the borrowers were out of town until next week.

Mary has worked that subdivision many times and knew that the tax assessor's estimate of value was typical of the area. This would be a loan to value ratio of 63% ($\$125,000/\$200,000$). Mary drove by the property, which appeared to be in a very good state of repair. Mary noticed a new in-ground pool, pool house, and privacy fence that were not on the tax card. She performed a Direct Sales Comparison Approach.

Considering the good exterior condition and the pool facilities, Mary's final opinion of value was \$225,000. She qualified this with a 25% range of accuracy. This means that the true value is anywhere from \$168,750 to \$281,250. This is a wide spread, but certainly shows that it is safe for Mike to make a \$125,000 first mortgage.

URAR TRADITIONAL SECONDARY MARKET

On September 12, 2002, Mary Smith, an appraiser, received a call from a mortgage broker. The broker requested her to do a traditional Fannie Mae secondary market appraisal.

Based on preliminary market data gathering, Mary felt the property was in the \$225,000 range. The home was 30 years old. While the exterior was in very good condition, she observed that most of the short-term interior items were worn and in need of replacement.

The owners said that they planned to totally redo the interior, as soon as their granddaughter finished at Harvard Law School. In fact, they had two bids on the work to be done. Both bids were about \$50,000.

Based on this and her other information she formed an opinion that the market value is \$175,000. She believed her value opinion to be within a 10% range of accuracy. This means that the true value is anywhere from \$157,500 to \$192,500.

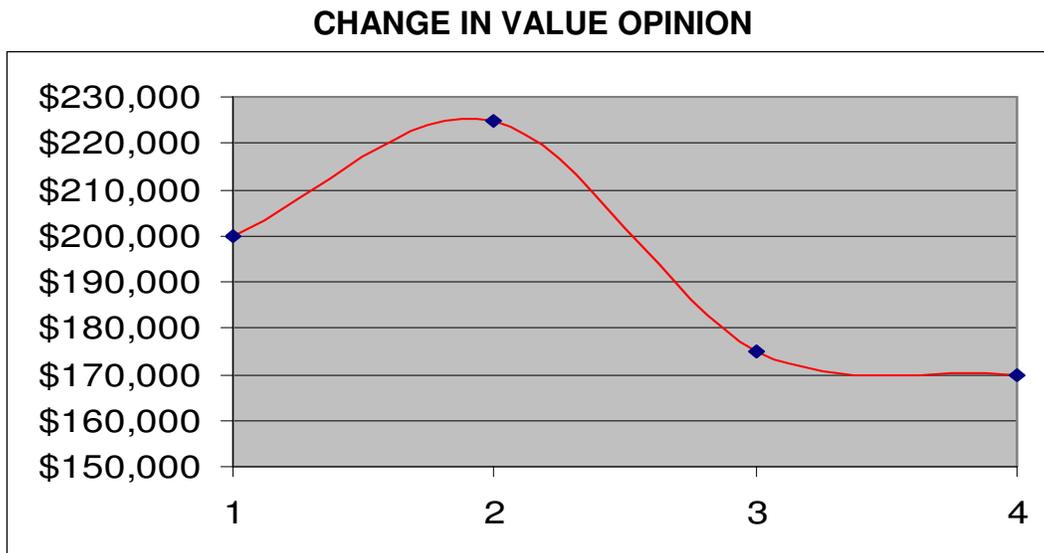
PURCHASE DECISION

On December 15, 2002, Mary Smith, an appraiser, received a call from a potential purchaser. The potential purchasers requested her to do an appraisal on their behalf.

Based on preliminary market data gathering, Mary felt the property was in the \$175,000 range. She considered this to be a situation where her opinion of value would have to be as reliable as possible. The buyers were not represented by a real estate sales person, nor were they especially knowledgeable concerning real estate. She expanded her scope of work from what is typically done for a Fannie Mae traditional secondary market URAR appraisal. She added a listing analysis and required a home inspection to be performed. The home inspection revealed some improper wiring and some old termite damage requiring some replacement of floor joists. The estimate to repair both items was \$5,000.

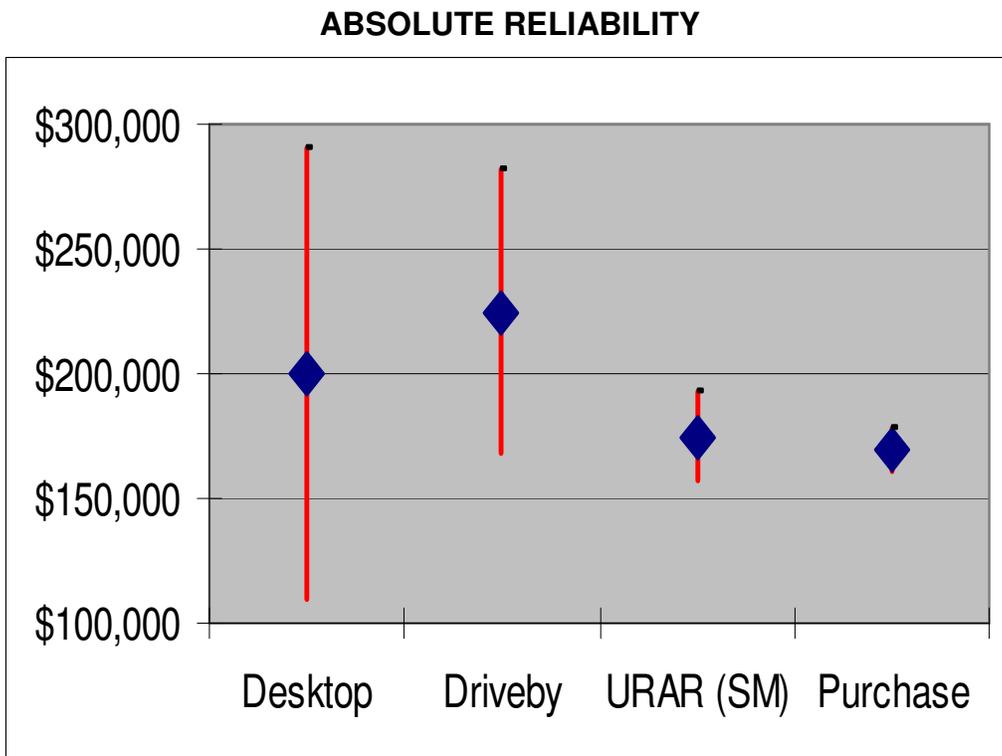
Based on this and her other information she formed an opinion that the market value is \$170,000. She believed her value opinion to be within a 5% range of accuracy. This means that the true value is anywhere from \$161,500 to \$178,500.

The following chart illustrates the variance in the value opinions by the same appraiser for the same property based on different levels of scope of work. The scope of work used is primarily a function of the intended use and the intended user. Users of appraisals need to be aware of the extent of the variance in an opinion of value that can result from a limited scope of work.



The following chart demonstrates that while each level of scope of work produced a different variance in value range, the actual value was always within that range. The actual value of a property should always be within any range of value given by the appraiser. The appraiser should expand the range of possible values to the appropriate extent in order to avoid misleading the intended user.

∞Actual Value: This term is not used in real appraisal practice and is theoretical. It is used in this booklet for illustrative purposes.



Locking up the Appraisal Report

The point of this exercise is very important. While an appraisal may be credible (reliable enough) for one use and user, the same appraisal may not be credible (adequately reliable) for a different use or user. Chapter 3 discussed some ways the appraiser can warn third parties of the risk of misusing the appraisal report. The “Desk Top Only” and the “Drive-by” situations analyzed above open the possibility of the intended user misusing the appraisal report. This following situation could occur: After the appraisal the loan to value ratio is increased to the point that the scope of work, specifically the method of gathering of the subject data, is no longer appropriate. In this situation the use of the appraisal changes from a “low risk loan transaction” to a “moderate or high risk loan transaction”. The intended user is not using the appraisal for the intended use. However, this is not clear if the appraisal report identifies the intended use as; “To provide information in conjunction with a mortgage loan.” The appraisal report could be “locked up” from misuse by the intended user in the following ways:

- Using a very specific intended user statement such as:
 - The intended use could be stated(as; “The intended use of this appraisal is to provide information in conjunction with a low risk mortgage loan.”
 - In the case of the “Desk Top” the intended use could be stated as; “The intended use of this appraisal is to provide information in conjunction with a \$30,000 first mortgage loan.”
 - In the case of the “Drive-by” the intended use could be stated as; “The intended use of this appraisal is to provide information in conjunction with a \$125,000 first mortgage loan.”
- Using “greater than” in the final value presentation:
 - For the “Desk Top” situation:
 - If the loan amount and loan to value ratio limit is known state that the final value opinion is “Greater than \$37,500”. This is the loan amount of \$30,000 divided by the loan to value ratio of 80%. Or,
 - State that the value opinion is “Greater that \$110,000”. See the situation for an explanation of the \$110,000.
 - For the “Drive-by” situation:
 - If the loan amount and loan to value ratio limit is known state that the final value opinion is “Greater than \$156,250”. This is the loan amount of \$125,000 divided by the loan to value ratio of 80%. Or,
 - State that the value opinion is “Greater that \$168,750”. See the situation for an explanation of the \$110,000.

There are an endless number of possible combinations of appraisal tasks representing the scope of work. To make matters worse the inclusion or exclusion of a specific task will affect the appraisal's reliability and cost from one geographical area to the next. An example is an area where large seller concessions are often made. Not gathering this data in such a market would be significant to the reliability of the appraisal. On the other hand, not gathering this data in a market that typically does not have seller concessions may have little effect on the reliability of the appraisal. There is little cost added to the appraisal by reading the warranty deed for restrictions in an area that has deeds readily accessible over the internet. However, in some rural areas a physical trip to the court house is required to obtain the deed. This could mean the appraiser will have additional driving and significant time associated with the performance of this task.

The reliability of the opinions and conclusions are determined by the breadth and depth of the Analysis and the Data Gathering, and the expertise of the analyzer and the data gatherer. Only an outline of the levels of analysis is presented here as an adequate knowledge base of this information exists. However, less has been written about the various data gathering methods, so it is broken down more thoroughly.

ANALYSIS

1. The approaches applied
2. The competency level of the analyst
3. The number of methods applied within the approaches.
4. The intensity of each method
 - a. The specific number of data sets considered
 - b. The number of characteristics considered within the data set

DATA GATHERING

1. The number of data records collected
2. The number of property characteristics gathered
3. The geographic location of the data gathered
4. The time period searched
5. The method used
 - a. Visual Inventory
 - i. Exterior from Curb
 - ii. Exterior on premises
 - iii. Interior by a walk through
 - iv. Land- walk over
 - b. Measurement
 - c. Research
 - i. Public

1. Tax records
 - a. Card
 - b. Plat
 2. Deeds
 3. Recorded Survey of site
 4. Published surveys
 - ii. Other
 1. MLS search
 2. Flood Zone Maps
 3. Seller's Disclosure Statement
 4. Zoning Information
 5. Operating Statements
 6. Data services
 7. Office records and files
 - d. Inspections
 - i. Home Inspection Report
 - ii. Engineering Studies
 - iii. Environmental Studies
 - e. Interviews
 - i. Other appraisers
 - ii. Sales professionals
 - iii. Buyer or seller
6. Quality of the data
 - a. Confirmation and verification
 - b. Inspection

It is important to make a distinction between a visual inventory and an inspection. Home inspectors perform “inspections”, while appraisers typically gather data by visual inventories.

∞Inspection: Verification that a component is functional and is in reasonable working order.



∞Visual Inventory: Inventory what and how many property components are on the subject property. This is done by “seeing” the various components. The accuracy depends on the extent of the property accessed.

Often, a property is only partially viewed even when the appraiser is accessing the interior. The scope of work should identify any areas that were not viewed, such as inaccessible areas, and accessible areas that were not viewed such as attics, roof coverings, crawls, etc.

In FHA appraisals the method data gathering for the subject property is a blend of Visual Inventory and Inspection.

Which is more important to the overall reliability of the appraisal, the scope of the analysis or the scope of the data gathering?

A modest analysis based on good data is better than an extensive analysis based on inaccurate data.

COSTING OUT THE APPRAISAL COMPONENTS

In comparing the advantages of one task over another task in an appraisal, both the value added to the reliability and the cost to perform that task must be considered. One of the challenges of engineering the specifications of the appraisal is the consideration of the costs associated with the various tasks that are applicable to the appraisal. The basic formula for costing out a task is:

$$\text{Cost} = \text{Hours} \times \text{Hourly Rate}$$

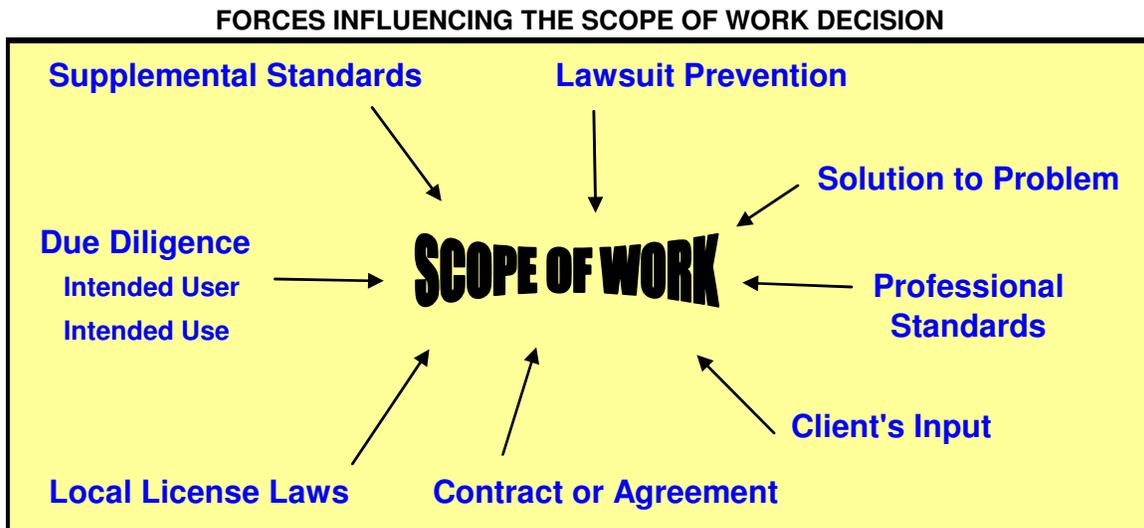
The *Hours* is simply the time that it will take to complete the task. The *Hourly Rate* is a predetermined rate based on the competency level of the person performing the task. Most appraisers can estimate the time it will take to perform many of the components of the appraisal based on experience. Some examples are performing the Cost Approach, inventorying the subject property visually from the exterior and interior, or driving by the comparable sales.

The hourly rate is somewhat alien to most appraisers. Typically, appraisal fees are quoted before the appraisal is started. This is probably the result of lenders including appraisal fee quotes in the Truth and Lending documentation, a form which must be provided to the potential borrowers at the beginning of the loan process. The form requires only an approximate appraisal fee, but most lenders are more comfortable using the actual fee. This is not the method my attorney uses. He quotes an hourly rate only. In fact, most of my phone calls are included in the billing time. Some appraisers use a hybrid of these methods by quoting an hourly rate where the fee will not exceed or be below a certain dollar amount. The dollar amount that is appropriate to charge can be estimated if the appropriate annual pay for the appraiser, trainee, or assistant is known. Our office manager quoted a certain fee for a specific residential appraisal. When the order came there was a requirement for an MAI to inspect the subject property and perform the analysis. The client seemed very confused when we submitted a higher fee quote for the job to compensate for the higher hourly rate of the MAI.

One method of determining a reasonable hourly rate for appraisers who work on a commission split is to start by setting an annual income figure. Some of the factors to consider are the typical income level of other professions in the area, cost of living in the area, experience level, related training and education, etc. The market balance (supply and demand of appraisers in the area) often plays a large role in what users of appraisals will pay for related services. Once an annual income target is set the appraiser will have to consider the following factors to calculate the hourly rate that will result in that annual income: expenses as a percent of gross income (education, camera, auto expense, etc.); hours worked per week; weeks worked in a year; appraiser's split rate; and the ratio of total time in the office to billing time.

If an hourly rate of \$50.00 is appropriate for the person who will perform the task, then if the particular task takes 30 minutes then it will cost about \$25.00 to perform. If two tasks or components in an appraisal add about the same reliability and one can be omitted then the one that adds more cost should be left off. This is not presented to fix the hourly rates that appraiser's charge, but only as an example. All of the parameters used to calculate an hourly rate will vary widely from area to area, and from appraiser to appraiser. In today's appraisal market, the users are solely concerned with the total fee, while appraisers should be more concerned about meeting an hourly rate than what the total fee is. The purpose of this booklet is to promote the appropriate scope of work for all types of assignments. Sometimes this will be more than the appraiser typically does and sometime it will be less. It is a misnomer that the appraiser will earn a higher hourly rate on an appraisal with intense scope and high fee, when compared to getting a low fee for an appraisal with a lesser scope of work. I am always asked what my fee will be; I have never been asked what hourly rate a job will generate to me.

CHAPTER 8 THE SCOPE OF WORK DECISION



The Appraisal Standards Board (ASB) makes this bold statement; “Of all the judgments and decisions that an appraiser makes in the course of an assignment, the scope of work decision is by far the most critical.”³⁸

This is so important I am going to repeat it: “Of all the judgments and decisions that an appraiser makes in the course of an assignment, the scope of work decision is by far the most critical.” “Wait a minute”, you may be saying to yourself, “it can’t be more important than the Direct Sales Comparison Approach or the Highest and Best use Analysis!” Let’s consider the ASB’s statement from a position of pure logic. Consider the following example illustrating how a conclusion can be determined from logic:

- 1- Zappy is a Martian
- 2- All Martians have purple ears.
- 3- Zappy has purple ears.

The logic is very straight forward and undisputable. If statements 1 and 2 are correct, then statement 3 is also correct, Zappy has purple ears. No doubt about it. Now consider the following logic:

- 1- *The SOW decision determines what appraisers are doing.*
- 2- *Appraisers do not know how to make a SOW decision*
- 3- *Appraisers do not know what they are doing.*

“Appraisers do not know what they are doing”! This is a very scary and sobering thought. I realize and accept that many appraisers are just not ready to hear this sort of thing.

A man convinced against his will, is of the same opinion still.

Dale Carnegie

Many appraisers are convinced that at the present speed and current course, the appraisal profession as we know it today will soon be extinct. What appraisers may find difficult to admit is that they (we in this case) are more than a little responsible for this situation. The statement made by the Appraisal Standards Board is a glimmer of light in a fading industry. Appraisers have the power to provide cost effective products and services to an ever changing market. In this Chapter we will explore the step by step process of making the scope of work decision.

THE SCOPE OF WORK DECISION

Appraisers have a very distinct mind set. This probably results from repeated education and training to solve a singular problem; forming an opinion of market value for a mortgage loan. To avoid confusion appraisers must thoroughly reconsider the content and meaning of current appraisal terminology. A good place to start is with the term “Scope of Work Decision”.

∞Scope of Work Decision: A process in which an opinion of the scope of work necessary to meet the due diligence requirements of the assignment is formed.

∞Relative Reliability: The relationship between the absolute reliability and the due diligence required in a specific assignment.

∞Relative Reliability Ratio: The ratio of the absolute reliability to the due diligence required in a specific assignment.

∞Credible (Appraising): When the pertinent information in an appraisal meets or exceeds the practical demands of the problem being solved or decision being

made for a particular class of intended users. An appraisal is credible when the relative reliability ratio is equal to or greater than one.

The definitions of *Appraisal*, *Credible*, and *Relative Reliability* presented here are the most important to the study of the scope of work decision. These definitions are based on USPAP which states:

“In developing a real property appraisal, an appraiser must identify the problem to be solved and the scope of work necessary to solve the problem, and correctly complete research and analysis necessary to produce a credible report.”³⁹

This statement is very simple yet very commanding in that its role is to introduce the entire “Standard 1”. It should be noted that this booklet is not limited to USPAP considerations as a driving force of due diligence and the scope of work.

The scope of work will determine to what degree the intended user’s position will be enhanced. But what level of enhancement is the appraiser responsible to achieve? This is largely a function of the market for appraisals. When banks are experiencing few losses on loans secured by owner occupied properties they will only want a minimal amount of enhancement in order to keep the costs of the appraisals to a minimum (see Chapter 1). On the other hand, if bad debt costs associated with this loan type become excessive lenders will want a higher degree of enhancement. These market expectations are an important part of assessing the due diligence associated with an assignment. After consideration of market expectations the degree of enhancement is more of a business decision than it is a mandate from an applicable body of authority. The main test of appraisal credibility is leaving the intended user(s) better off than they would have been without considering the pertinent appraiser-generated information.

TASKS INVOLVED IN THE SCOPE OF WORK DECISION

The scope of work decision is one of a series of decisions (opinions and conclusions) that is formed in the appraisal. The scope of work decision involves the following steps:

STEPS IN THE SOW DECISION

I. Diagnose the Problem



II. Develop a Solution



III. Assess the Due Diligence



IV. Form an Opinion of the SOW



V. Communicate the SOW

The exact same table was presented at the beginning of this booklet, but it was titled the “APPRAISAL PLANNING PROCESS”. This coincidence implies that the steps for the Scope of Work Decision are the exact same steps as in the Appraisal Planning Process. Is the Scope of Work Decision a small subpart of the Appraisal Planning Process or is it effectively the Appraisal Planning Process? It makes sense that the *Appraisal Planning Process* and the *Scope of Work Decision* are essentially the same thing. They both determine what tasks the appraiser will perform in the appraisal. The title *Scope of Work Decision* emphasizes that it is still planning, but with more of an emphasis on analysis. The *Scope of Work Decision* discriminates among the possible analysis and data gathering methods and techniques, choosing the combination that best suits the assignment. It considers the effect of reliability and cost on the intended user’s position.

Step I and II were presented in Chapter 5, and Step III was covered in Chapter 6. Chapter 8 led up to Step IV and this Chapter will focus on forming an opinion of the scope of work.

DEVELOP AN OPINION OF THE SCOPE OF WORK:

- What analyses will be required?
 - Cost Approach
 - DSCA
 - Income Approach
 - GRM
 - Capitalization
 - Discounted Cash flow
 - Highest & Best Use
- How intensely should each analysis be made?
- How intense should the data gathering process be?
 - Where gathered.
 - Which sources (just MLS or tax cards, door to door)
 - Extent of property access
 - Interior & exterior
 - Exterior only
 - Curb-side
 - None
 - Method
 - Visual
 - Research
 - Measurement
 - Conjecture
 - Inspection
 - Extent of substantiation
 - Verification
 - Collaboration
 - None

TEST THE SCOPE OF WORK OPINION

1. Will the problem be solved, or will the information aid in its solution?
2. Are there any contingencies?
3. Could less work be done and the problem would still be solved?
4. Will information not related to problem need to be gathered?
5. Have any third parties made you aware that they plan to use and rely on the Appraisal?
6. Will all supplemental standards be met?
 - a. Is the value definition and source correct?
7. Is the expected range of error appropriate for the risk tolerance of all intended users?
8. Is the appraiser appropriate?
 - a. Competent
 - i. If not outline the steps necessary to become competent
 - b. Legal by license
 - c. Does the appraiser have any bias?
9. Is the Scope appropriate for the type of property?
10. Is the scope similar to what the appraiser's peers would do?
11. Is the scope typical of what this market segment of users expects?
12. If any of these questions is answered "No", the appraiser must question whether the scope of work is sufficient to solve the problem as defined.

Final Requirements:

- Does this level of scope of work meet your personal minimum business practice?
- Get approval of client.
 - If not approved then expand scope of work.
 - If approved then the scope of work has been adequately developed.

If you cannot agree with the client then do not accept the assignment. USPAP states that; “An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal.”⁴⁰

CHAPTER 9 REPORTING THE SCOPE OF WORK

REASONS FOR REPORTING THE SCOPE OF WORK

Once the appraisal planning process is complete and the appraisal has been performed the pertinent information (opinions and conclusions) must be reported to the client. This information has little use without some qualification. Imagine a lion hunter in Africa opening a box labeled "Rifle". A rifle is certainly a solution to the hunter's needs. When the rifle is fired at the lion the hunter noticed the shot was not very loud, and the direct hit did not seem to disable the lion. A close inspection of the cartridge revealed the rifle to be a .22 caliber. As the lion charged, the hunter concluded there was a serious problem. The rifle should have been better described (qualified) to the user. Another example of the need to qualify information can often be seen on the TV show "Who Wants To Be A Millionaire?". One of the "life-lines" on the show allows the contestant to phone a friend when he/she is not certain of the correct answer. Most of the time when the friend phoned gives an answer, the contestant will ask, "How sure are you"? The information provided by the friend cannot be properly used without this qualification. The intended user of the appraisal, likewise, wants to know how sure the appraiser is about the pertinent information provided.

One of the best measures of qualification is the degree of confidence. Appraising has not reached the sophistication that would allow for a qualification of the opinions and conclusions to be reported as a confidence level such as "The value opinion of \$100,000 plus or minus 10% will occur 95% of the time". In appraising we use the general term *reliability*. Because the reliability of the appraiser's conclusions and opinions is not presented as a statistical confidence level it is by definition subjective. One way to qualify the appraisal results to the intended user is to provide a description of the scope of work. The purpose of reporting the scope of work is to qualify the information to the intended user so that the information may effectively be used in the decision making process.

"Documenting the scope of work provides the intended users with a clear understanding of the extent of research and analysis. It also serves as protection for both the client and the appraiser by detailing things that were, and were not, done in the assignment. Other professionals, such as engineers, have a long history of requiring the development and reporting of the scope of work in their assignments."⁴¹

Historically, appraisers have had a narrow range of assignments in their appraisal practice. Residential appraisers have been able to rely on the URAR form, and commercial appraisers have been able to rely on their trusted narrative template to handle these assignments. Today, most appraisers are entertaining

expanding the range of their services to include new types of assignments. Appraisers are unsuccessfully trying to make these unique assignments fit their forms and templates.

When the only tool you own is a hammer, every problem begins to resemble a nail. ---Abraham Maslow

Unfortunately, it is not the assignments that need to be molded to fit the forms and templates; *it is the forms and templates that need to be modified to fit the assignment.* It is no wonder that appraisers feel like they are trying to put a square peg into a round hole when trying to appraise different types of assignments.



METHODS OF REPORTING THE SCOPE OF WORK

There are at least four methods for writing a description of the scope of work in the appraisal report:

1. a general summary for the entire appraisal at the beginning of the report;
2. a general summary at the beginning and /or end of the development of each opinion and conclusion;
3. augmenting the various forms and templates; and
4. referencing a predefined scope of work description.

Most appraisers are currently reporting parts of the scope of work description throughout the appraisal report. Parts of the scope of work are presented on some forms, in certifications, in assumptions & limiting conditions, and in the final reconciliation sections of the report. Anywhere in the appraisal report that the appraiser tells what was done, or not done, or how it was done, is part of the scope of work.

Method 1 is not practical as it would repeat statements that are already in other parts of the report. Although Method 1 is not practical for a full description it does serve as a good place to report an overview of the scope of work. It should be titled as “Overview of the Scope of Work” and state the main conclusions that will be made (highest & best use, effective age, exposure time, market value, etc.), the analysis used to make them, and the data gathering methods used to obtain various data.

Method 2 is perhaps more appropriate for narrative reports. At each point that an opinion or conclusion is reached the extent of the research and analysis is reported. This method is not practical on standardized forms as entry lines are not available near each opinion and conclusion. But is a good idea to include the “Overview of the Scope of Work” discussed above in conjunction with method.

Method 3 is the most practical way to deal with reporting the scope of work on a standardized form. This method permits deficiencies to be identified and reported. Each standardized form has a unique set of deficiencies that need to be addressed.

Method 4 is the direction that our profession may have to take. Methods 1, 2, and 3 are time-consuming and difficult to perform. Even if appraisers were to perform these methods, they will add cost to the appraisal. A solution is for our profession to agree on some predefined levels of scope of work. These levels would primarily be defined by the users of appraisals and as market phenomena need to be modified from time to time. For example the current extent of subject property data gathering (see Chapter 7) might be a good way to start. A *Level I* might be associated with a desk top method, A *Level II* would be associated with a curb-side method, A *Level III* would be associated with an inventory conducted on the interior and exterior of the property, and a *Level IV* would include to some degree actual inspection of the components of the subject property. Each of these levels would describe the level of the scope of work for all aspects of the appraisal, including the level of verification of data, the approaches to value used, etc.

Until referencing a predefined scope of work description is implemented Method 3, *Augmentation* will have to be used for most form appraisals, and as a means of presenting an overview of the scope of work in narrative reports. The following is a suggested outline of a properly reported scope of work:

SUGGESTED STEPS IN REPORTING THE SCOPE OF WORK:

1. Provide an overview of the assignment near the beginning of the report. It should contain a statement of the following information:
 - a. The type of reporting format used.
 - b. Identification of the client and intended users.
 - c. Intended use
 - d. Identify the “Primary Information” that the appraiser has generated to enhance the intended user’s decision making process.
 - i. Identify the type and definition of value.
 - e. Limiting Conditions
 - f. General Assumptions
 - g. Scope of work
 - i. Identify any Hypothetical Conditions
 - ii. Identify any Extraordinary Assumptions
 - h. Appraiser’s certification
2. The bulk of the reporting should be in the reconciliation of each approach to value. USPAP’s description of “Stating, Summarizing, and Describing” should be utilized in the writing style. Special emphasis should be on showcasing the tasks performed. For example if any data was obtained or verified by a personal interview, then that should be included.
 - a. Present the level of scope of work for the analysis.
 - b. Present the level of scope of work of the data gathering process.

Overview of the Assignment

Writing an overview of the assignment can be difficult and a time consuming process. The appraiser must have a checklist of the topics to be covered and then customize the statements to fit the particular assignment. However, this can be more easily accomplished than generally believed. My appraisal office has been using a computer assisted system to augment appraisal reports since 1998. The first system was called the “Procedural Outline Program” (POP) and it automatically made conclusions about documentation based on the answers to a series of questions. However, it still was not flexible enough to handle all assignments properly. It was also weak in addressing concerns about liability management, which had just emerging as a concern. A new system was designed and implemented by my company a few years ago. It is called the “USL Documenter”. The initials are acronyms for USPAP, Supplemental Standards, and Liability Management. It is designed to allow appraisers with at least a rudimentary understanding of scope of work concepts and its driving forces to quickly and properly document a report for most any assignment. It goes beyond the scope of work reporting requirements and addresses USPAP, Supplemental Standards, and Liability management. The use of this system is being provided to you in conjunction with this booklet. The files associated with

the USL Documenter can be downloaded for free at www.braunappraisal.com along with an instruction booklet.

The USL Documenter is a computer program that runs in Microsoft Excel™. It has been programmed to recognize the deficiencies of the various standardized forms and the requirements associated with them. This documenter stores and retrieves the various standardized phrases that are presented in Addenda (G). These phrases can be modified and added to. The document that is created can be copied and pasted into a multi-page addendum in many appraisal software programs, and into most word processors. The USL Documenter will use its own customized certifications, assumptions and, limiting conditions unless they are not allowed by applicable supplemental standards. This Documenter also serves as a stand alone restricted use report. The current version does not recognize the new FANNIE MAE forms, but an updated version is being programmed and will soon be available for download.

Reconciliation of the Approaches

The Overview of the Assignment section described above “states” various information. This complies with USPAP’s reported format for a Restricted Use report. However, USPAP requires that the scope of work be “summarized” in a summary report format, and “described” in a Self-Contained format.⁴² In order to meet this requirement the scope of work performed in the approaches should be iterated in the reconciliation section of the report. This is a natural place to include the scope of work as it helps to explain quality (reliability) of the specific approaches. An example is not presented here as much has already been written on this subject. It is not certain that doing anymore than “stating” the scope of work adds to the quality or usefulness of the report. The current USPAP reporting requirements for the scope of work may be unnecessarily cumbersome.

Reporting the extent of the data gathering process

A sample statement of the source and extent of the data gathering process might be: *The Sales information listed was taken from public records and verified by the seller. The financial information was extracted from copies of two years of tax returns. The property information was obtained by a recent visual inventory of the property by an appraiser in this office.*

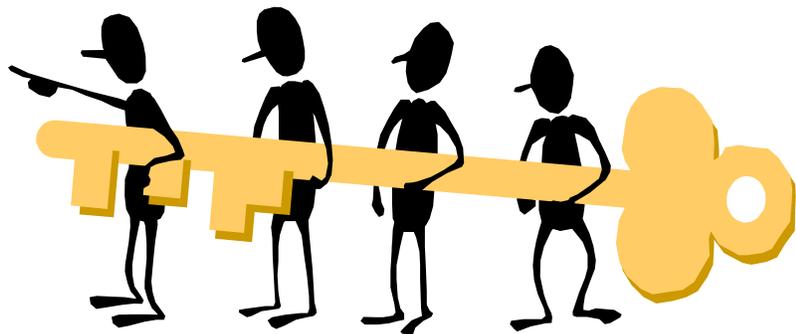
CHAPTER 10 ADIEU

This writing highlights the author's prospective of what is expected of the appraiser in this new millennium. It has been published to promote the appraisal profession. This profession is not an entity within itself, but is made up of a diverse group of individuals. I believe that there is no substitute for the neighborhood appraiser, and that there is more need for appraisal services than ever. I cannot assure the reader that his/her State's Appraiser Commission will agree with all views presented in this booklet. However, I believe that for many appraisers the application of the information presented here will improve the quality and professionalism of their appraisal practice.

The intent was to present a basic and logical concept of the "Scope of Work" to the working professions (appraisers and users of appraisals). Hopefully, the information was presented in a basic and fundamental way so that the material was both readable and comprehensible. The USL Documenter software was provided because no matter how well the appraiser knows what he/she is doing the appraiser must have an efficient means to document their reports in consideration of USPAP, Supplemental Standards, and Liability Management.

Those that have read most of this Booklet have probably correctly concluded that the author is an appraiser and not a professional writer. It is my hope to produce a second edition of this work timed to come out shortly after the next USPAP edition that is scheduled for some time in 2006. I intend for it to be better written and have the content that readers want. Your comments, corrections, and ideas for additional comment are needed. Should there be more supplemental standards covered such as FHA, Secondary Market, or more examples of how to plan and document unique types of appraisals? Please send comments to dbraun@braunappraisal.com.

The real key to elevating the appraisal industry to a profession is by appraisers working together to accomplish tasks that cannot be accomplished by an individual. One method would be to create an appraiser's task force that would function under the supervision of the Appraisal Subcommittee. This task force would be charged with creating new tools and resources to enhance the effectiveness of the appraiser. The typical



neighborhood appraiser will accomplish the duty of serving the public as long as he/she has the means (knowledge, training, and technology) to do so. This would basically be a Research and Development (R&D) for the profession. The Appraiser's Task Force (ATF) would work with groups that create forms, the Appraisal Foundation, software vendors, professional appraisal organizations, etc.

Let me tell you an interesting story:

A Farmer's Parable

A parable is told of a farmer who owned an old mule. The mule fell into the farmer's well. The farmer heard the mule braying. After carefully assessing the situation, the farmer sympathized with the mule but decided that neither the mule nor the well was worth the trouble of saving. Instead, he called his neighbors together and told them what had happened. He enlisted their help to shovel dirt into the well and to bury the old mule to put him out of his misery.



Initially, the old mule was hysterical. But as the farmer and his neighbors continued shoveling and the dirt hit his back, a thought hit him; every time a shovel full of dirt hit his back, he would shake it off and step up. He did this blow after blow. "Shake it off and step up...shake it off and step up... shake it off and step up", he repeated to encourage himself.

No matter how painful the blows or distressing the situation seemed, the old mule fought off panic and kept right on shaking it off and stepping up. It wasn't long before the old mule, battered and exhausted, stepped over the wall of the well.

Although it seemed the dirt would bury him, it actually served as his way out of the dilemma, all because of the way he handled the adversity.

As with life: If we face our problems and respond to them positively, and refuse to give in to panic, bitterness or self-pity, the adversities that come along to bury us have the potential to benefit us instead.

Author Unknown

ADDENDA (A) FEDERAL BANKING REGULATIONS

**Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision**

LETTER DATED OCTOBER 27, 1994

Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies) are jointly issuing these guidelines, which supersede each of the agencies' appraisal and evaluation guidelines issued in 1992. These guidelines address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions and provide guidance to examining personnel and federally regulated institutions about prudent appraisal and evaluation policies, procedures, practices, and standards.

Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires the agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions. Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective State supervision.

Common agency regulations issued pursuant to Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) also require each regulated institution to adopt and maintain written real estate lending policies that are consistent with safe and sound banking practices and that reflect consideration of the real estate lending guidelines attached to the regulation. The real estate lending guidelines state that a real estate lending program should include an appropriate real estate appraisal and evaluation program.

Supervisory Policy

An institution's real estate appraisal and evaluation policies and procedures will be reviewed as part of the examination of the institution's overall real estate-related activities. An institution's policies and procedures should be incorporated into an effective appraisal and evaluation program. Examiners will consider the institution's size and the nature of its real estate-related activities when assessing

the appropriateness of its program.

When analyzing individual transactions, examiners will review an appraisal or evaluation to determine whether the methods, assumptions, and findings are reasonable and in compliance with the agencies' appraisal regulations, policies, supervisory guidelines, and the institution's policies. Examiners also will review the steps taken by an institution to ensure that the individuals who perform its appraisals and evaluations are qualified and are not subject to conflicts of interest. Institutions that fail to maintain a sound appraisal or evaluation program or to comply with the agencies' appraisal regulations, policies, or these supervisory guidelines will be cited in examination reports and may be criticized for unsafe and unsound banking practices. Deficiencies will require corrective action.

Appraisal and Evaluation Program

An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish an effective real estate appraisal and evaluation program. The program should:

1. Establish selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals or evaluations; Provide for the independence of the person performing appraisals or evaluations;
2. Identify the appropriate appraisal for various lending transactions;
3. Establish criteria for contents of an evaluation;
4. Provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the underwriting decision;
5. Assess the validity of existing appraisals or evaluations to support subsequent transactions;
6. Establish criteria for obtaining appraisals or evaluations for transactions that are otherwise exempt from the agencies' appraisal regulations; and
7. Establish internal controls that promote compliance with these program standards.

Selection of Individuals Who May Perform Appraisals and Evaluations

An institution's program should establish criteria to select, evaluate, and monitor the performance of the individual(s) who performs a real estate appraisal or evaluation. The criteria should ensure that:

1. The institution's selection process is non-preferential and unbiased;
2. The individual selected possesses the requisite education, expertise and competence to complete the assignment;
3. The individual selected is capable of rendering an unbiased opinion; and
4. The individual selected is independent and has no direct or indirect interest, financial or otherwise, in the property or the transaction.

Under the agencies' appraisal regulations, the appraiser must be selected and engaged directly by the institution or its agent. The appraiser's client is the institution, not the borrower. An institution may use an appraisal that was prepared by an appraiser engaged directly by another financial services institution, as long as the institution determines that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

Independence of the Appraisal And Evaluation Function

Because the appraisal and evaluation process is an integral component of the credit underwriting process, it should be isolated from influence by the institution's loan production process. An appraiser and an individual providing evaluation services should be independent of the loan and collection functions of the institution and have no interest, financial or otherwise, in the property or the transaction. If absolute lines of independence cannot be achieved, an institution must be able to clearly demonstrate that it has prudent safeguards to isolate its collateral evaluation process from influence or interference from the loan production process.

The agencies recognize, however, that it is not always possible or practical to separate the loan and collection functions from the appraisal or evaluation process. In some cases, such as in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, or directors should abstain from any vote or approval involving loans on which they performed an appraisal or evaluation.

Transactions That Require Appraisals

Although the agencies' appraisal regulations exempt certain categories of real estate-related financial transactions from the appraisal requirements, most real estate transactions over \$250,000 are considered federally related transactions and thus require appraisals. A "federally related transaction" means any real estate-related financial transaction in which the agencies engage, contract for, or regulate, and that requires the services of an appraiser. An agency also may impose more stringent appraisal requirements than the appraisal regulations require, such as when an institution's troubled condition is attributable to real estate loan underwriting problems.

Minimum Appraisal Standards

The agencies' appraisal regulations include five minimum standards for the preparation of an appraisal. The appraisal must:

1. Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP)

- promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation unless principles of safe and sound banking require compliance with stricter standards; Although allowed by USPAP, the agencies' appraisal regulations do not permit an appraiser to appraise any property in which the appraiser has an interest, direct or indirect, financial or otherwise.
2. Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction; As discussed below, appraisers have available various appraisal development and report options; however, not all options may be appropriate for all transactions. A report option is acceptable under the agencies' appraisal regulations only if the appraisal report contains sufficient information and analysis to support an institution's decision to engage in the transaction.
 3. Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units; This standard is designed to avoid having appraisals prepared using unrealistic assumptions and inappropriate methods. For federally related transactions, an appraisal is to include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. For properties where improvements are to be constructed or rehabilitated, the regulated institution may also request a prospective market value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development for the purpose of the agencies' appraisal regulations. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commission, rent losses, and tenant improvements from an estimate based on stabilized occupancy.
 4. Be based upon the definition of market value set forth in the regulation; and Each appraisal must contain an estimate of market value, as defined by the agencies' appraisal regulations.
 5. Be performed by State-licensed or certified appraisers in accordance with requirements set forth in the regulation.

Appraisal Options

An appraiser typically uses three market value approaches to analyze the value of a property: cost, income, and comparable sales -- and reconciles the results of each to estimate market value. An appraisal will discuss the property's recent sales history and contain an opinion as to the highest and best use of the property. An appraiser must certify that he/she has complied with USPAP and is

independent. Also, the appraiser must disclose whether the subject property was inspected and whether anyone provided significant assistance to the person signing the appraisal report.

An institution may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraiser must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value. Departure from standards designated as binding requirements is not permitted.

An institution and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the institution or other intended users of the appraisal report. The agencies do not prohibit the use of a Limited Appraisal for a federally related transaction, but the agencies believe that institutions should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files. The agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of an institution's real estate transactions and under other circumstances when an institution's program requires an evaluation.

Moreover, since the institution is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The institution's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written engagement letter that outlines the institution's

expectations and delineates each party's responsibilities, especially for large, complex, or out-of-area properties.

Transactions That Require Evaluations

A formal opinion of market value prepared by a State licensed or certified appraiser is not always necessary. Instead, less formal evaluations of the real estate may suffice for transactions that are exempt from the agencies' appraisal requirements. The agencies' appraisal regulations allow an institution to use an appropriate evaluation of the real estate rather than an appraisal when the transaction:

1. Has a value of \$250,000 or less;
2. Is a business loan of \$1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
3. Involves an existing extension of credit at the lending institution, provided that:
 - a. there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or
 - b. there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

Institutions should also establish criteria for obtaining appraisals or evaluations for safety and soundness reasons for transactions that are otherwise exempt from the agencies' appraisal regulations.

Evaluation Content

An institution should establish prudent standards for the preparation of evaluations. At a minimum, an evaluation should:

1. Be written; Include the preparer's name, address, and signature, and the effective date of the evaluation;
2. Describe the real estate collateral, its condition, its current and projected use;
3. Describe the source(s) of information used in the analysis;
4. Describe the analysis and supporting information, and;
5. Provide an estimate of the real estate's market value, with any limiting conditions.

An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates

prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation should provide an estimate of value to assist the institution in assessing the soundness of the transaction. Prudent practices also require that as an institution engages in more complex real estate-related financial transactions, or as its overall exposure increases, a more detailed evaluation should be performed. For example, an evaluation for a home equity loan might be based primarily on information derived from a sales data services organization or current tax assessment information, while an evaluation for an income-producing real estate property should fully describe the current and expected use of the property and include an analysis of the property's rental income and expenses.

Qualifications of Individuals Who Perform Evaluations

Individuals who prepare evaluations should have real estate-related training or experience and knowledge of the market relevant to the subject property. Based upon their experience and training, professionals from several fields may be qualified to prepare evaluations of certain types of real estate collateral. Examples include individuals with appraisal experience, real estate lenders, consultants or sales persons, agricultural extension agents, or foresters. Institutions should document the qualifications and experience level of individuals whom the institution deems acceptable to perform evaluations. An institution might also augment its in-house expertise and hire an outside party familiar with a certain market or a particular type of property. Although not required, an institution may use State licensed or certified appraisers to prepare evaluations. As such, Limited Appraisals reported in a Summary or Restricted format may be appropriate for evaluations of real estate-related financial transactions exempt from the agencies' appraisal requirements.

Valid Appraisals and Evaluations

The agencies allow an institution to use an existing appraisal or evaluation to support a subsequent transaction; if the institution documents that the existing estimate of value remains valid. Therefore, a prudent appraisal and evaluation program should include criteria to determine whether an existing appraisal or evaluation remains valid to support a subsequent transaction. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace, and the nature of any subsequent transaction. Factors that could cause changes to originally reported values include: the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. The institution must document the information sources and analyses used to

conclude that an existing appraisal or evaluation remains valid for subsequent transactions.

Renewals, Refinancings, and Other Subsequent Transactions

While the agencies' appraisal regulations generally allow appropriate evaluations of real estate collateral in lieu of an appraisal for loan renewals and refinancings, in certain situations an appraisal is required. If new funds are advanced over reasonable closing costs, an institution would be expected to obtain a new appraisal for the renewal of an existing transaction when there is a material change in market conditions or the physical aspects of the property that threatens the institution's real estate collateral protection.

The decision to reappraise or reevaluate the real estate collateral should be guided by the exemption for renewals, refinancings, and other subsequent transactions. Loan workouts, debt restructurings, loan assumptions, and similar transactions involving the addition or substitution of borrowers may qualify for the exemption for renewals, refinancings, and other subsequent transactions. Use of this exemption depends on the condition and quality of the loan, the soundness of the underlying collateral and the validity of the existing appraisal or evaluation.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptance of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

An institution may engage in a subsequent transaction based on documented equity from a valid appraisal or evaluation, if the planned future use of the property is consistent with the use identified in the appraisal or evaluation. If a property, however, has reportedly appreciated because of a planned change in use of the property, such as rezoning, an appraisal would be required for a federally related transaction, unless another exemption applied.

Program Compliance

An institution's appraisal and evaluation program should establish effective internal controls that promote compliance with the program's standards. An individual familiar with the appropriate agency's appraisal regulation should ensure that the institution's appraisals and evaluations comply with the agencies' appraisal regulations, these guidelines, and the institution's program. Loan administration files should document this compliance review, although a detailed analysis or comprehensive analytical procedures are not required for every

appraisal or evaluation. For some loans, the compliance review may be part of the loan officer's overall credit analysis and may take the form of either a narrative or a checklist. Corrective action should be undertaken for noted deficiencies by the individual who prepared the appraisal or evaluation.

An institution's appraisal and evaluation program should also have comprehensive analytical procedures that focus on certain types of loans, such as large-dollar credits, loans secured by complex or specialized properties, non-residential real estate construction loans, or out-of-area real estate. These comprehensive analytical procedures should be designed to verify that the methods, assumptions, and conclusions are reasonable and appropriate for the transaction and the property. These procedures should provide for a more detailed review of selected appraisals and evaluations prior to the final credit decision. The individual(s) performing these reviews should have the appropriate training or experience, and be independent of the transaction.

Appraisers and persons performing evaluations should be responsible for any deficiencies in their reports. Deficient reports should be returned to them for correction. Unreliable appraisals or evaluations should be replaced prior to the final credit decision. Changes to an appraisal's estimate of value are permitted only as a result of a review conducted by an appropriately qualified State licensed or certified appraiser in accordance with Standard III of USPAP.

Portfolio Monitoring

The institution should also develop criteria for obtaining reappraisals or reevaluations as part of a program of prudent portfolio review and monitoring techniques -- even when additional financing is not being contemplated. Examples of such types of situations include large credit exposures and out-of-area loans.

Referrals

Financial institutions are encouraged to make referrals directly to state appraiser regulatory authorities when a State licensed or certified appraiser violates USPAP, applicable state law, or engages in other unethical or unprofessional conduct. Examiners finding evidence of unethical or unprofessional conduct by appraisers will forward their findings and recommendations to their supervisory office for appropriate disposition and referral to the state, as necessary.

Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of Thrift Supervision
National Credit Union Administration

FREQUENTLY ASKED QUESTIONS ON THE APPRAISAL REGULATIONS AND THE INTERAGENCY STATEMENT ON INDEPENDENT APPRAISAL AND EVALUATION FUNCTIONS

March 22, 2005

See OCC: AL 2003-9; FRB: SR letter 03-18; FDIC: FIL-84-2003; OTS: CEO letter 184;
and NCUA: LTCU 03-CU-17.

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision and the National Credit Union Administration (the agencies) prepared this document in response to questions from federally regulated institutions (regulated institutions) on existing standards for selecting appraisers, ordering appraisals, accepting transferred appraisals, and other related topics. It should be reviewed in conjunction with the agencies' appraisal regulations, the "Interagency Appraisal and Evaluation Guidelines" (interagency guidelines), dated October 27, 1994, and the joint statement "Independent Appraisal and Evaluation Functions" (independence statement), dated October 28, 2003.

SELECTING AN APPRAISER AND ORDERING AN APPRAISAL

1. Do the interagency guidelines and independence statement apply for ordering and reviewing appraisals if the collateral property is residential (mortgage or home equity) rather than commercial?

Answer: The agencies' guidance applies to both commercial and residential transactions. While the guidance does not differentiate between commercial and residential transactions, a regulated institution's appraisal policy and practices may differ for certain transactions. The regulated institution needs to consider the type of transaction when ordering appraisals, selecting appraisers, and reviewing appraisals. The transaction type should influence the type of appraisal that the regulated institution orders and whether the appraisal is eligible for a compliance review or

should receive a comprehensive, analytical review prior to the credit decision. Moreover, for all lending activity, a regulated institution should ensure that independence is maintained when selecting appraisers, ordering appraisals, and reviewing appraisals.

2. *A regulated institution plans to make a construction loan to a tract developer to build 10 homes. Is it permissible for the developer to order appraisals on the properties and use them to support the construction loan request? Could the developer select an appraiser from the lender's approved appraiser list and in turn submit the appraiser's name to potential permanent lenders?*

Answer: No, the regulated institution may not accept a borrower-ordered appraisal and may not allow the borrower to select an appraiser from its approved appraiser list.

3. *Who should be considered the loan production staff for purposes of achieving appraiser independence? Could loan production staff select an appraiser?*

Answer: The loan production staff consists of those responsible for generating loan volume or approving loans, as well as their subordinates. This would include any employee whose compensation is based on loan volume. Employees responsible for the credit administration function or credit risk management are not considered loan production staff.

Loan production staff should not select appraisers. However, in a small or rural institution or branch, the only individual qualified to analyze the real estate collateral may also be a loan officer, other officer, or director of the institution. To ensure their independence, such lending officials, officers, and directors should abstain from any vote or approval involving loans for which they engaged the appraiser, reviewed the appraisal, or performed an evaluation.

4. *What information should the regulated institution provide to the appraiser upon engagement?*

Answer: The regulated institution should provide the property's address, its description, and any other relevant information. The regulated institution may also provide a copy of the sales contract for purchase transactions. However, the information provided by the regulated institution should not unduly influence the appraiser or in any way suggest the property's value. The regulated institution and the appraiser should agree on the scope of the appraisal in advance, consistent with the Uniform Standards of Professional Appraisal Practice (USPAP) and the agencies' appraisal regulations and interagency guidelines.

5. *When selecting residential appraisers, may loan production staff use a revolving pre-approved appraiser list, provided the list is not under their control?*

Answer: Yes, loan production staff may use a revolving, board-approved list to select a residential appraiser, provided the development and maintenance of the list is not

under their control. Staff responsible for the development and maintenance of the list should be independent of the loan production process. In developing the list, a regulated institution should consider the knowledge and expertise of the selected appraiser for a given assignment. For example, the list should indicate the qualifications of the appraiser to perform appraisals in particular markets and on various types of residential property transactions. If the next available name on the list is not selected, the departure should be properly documented in the credit file. The administrative procedures should include a process for qualifying an appraiser for initial placement on the list as well as for periodic monitoring of the appraiser's performance to assess whether to retain an appraiser on the list. Further, there should be periodic internal review of the appraiser selection process to ensure that appropriate procedures are being followed and that controls exist to ensure independence.

6. *Must the individual appraiser, rather than the appraisal firm, sign and accept the terms of an engagement letter for it to be considered valid?*

Answer: The agencies have no specific requirements with respect to who signs and accepts the engagement letter. The appraiser, however, must sign the certification page of the appraisal report.

7. *Are appraisers required to disclose whether they have been engaged to appraise a given property in the past or is this information confidential?*

Answer: The agencies' appraisal regulations do not require that the regulated institution obtain information from appraisers as to whether they have previously appraised a given property. However, the regulations do require when engaging a fee appraiser that the regulated institution ensures that the appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction. The regulated institution should ask relevant questions of an appraiser to ensure that the appraiser is independent of the transaction and capable of rendering an unbiased opinion.

8. *When ordering appraisals, can a staff appraiser or an appraisal company affiliated with the regulated institution be considered independent since the regulated institution compensates them?*

Answer: Yes, if a staff appraiser prepares an appraisal, that appraiser must be independent of the lending, investment, and collections functions and not involved in the approval of the transaction. When fee appraisers from an affiliated appraisal company prepare appraisals, similar independence standards apply.

ACCEPTING A TRANSFERRED APPRAISAL

9. *Can a regulated institution accept an appraisal from a prospective borrower and determine its acceptability based on a review?*

Answer: No, a regulated institution cannot accept a borrower-ordered appraisal.

10. *Can an appraisal be transferred from one lender to another and, if so, under what circumstances?*

Answer: A regulated institution may accept an appraisal transferred from another regulated institution or from a financial services institution (that is, a non-regulated institution), provided 1) the appraiser is engaged directly by the institution transferring the appraisal, 2) the appraiser has no direct or indirect interest in the property or transaction, 3) the existing appraisal or evaluation remains valid, and 4) the regulated institution determines that the appraisal conforms to the agencies' appraisal requirements and interagency guidelines and is otherwise appropriate. (A financial services institution describes entities that provide services in connection with real estate lending transactions on an ongoing basis.)

Regulated institutions are expected to perform a more thorough review when accepting an appraisal from another financial services institution to confirm that the appraisal complies with the regulation and has sufficient information to support the lending decision. Moreover, the regulated institution accepting the appraisal should determine whether appropriate documentation is available to confirm that the financial services institution (not the borrower) ordered the appraisal.

11. *Can a regulated institution accept an appraisal prepared by an appraiser who was engaged by a loan broker?*

Answer: The agencies' appraisal regulations allow a regulated institution to accept an appraisal prepared by an appraiser engaged by another financial services institution, including a loan broker. This is allowed as long as the regulated institution has appropriate controls in place to ensure that the appraiser is acting on behalf of the financial services institution, the appraisal conforms to the requirements of the regulation and is otherwise acceptable, and the appraiser is independent from the borrower. Regulated institutions should review broker-ordered appraisals thoroughly to ensure that the appraisal complies with the regulation and meets the quality standards required by the institution's appraisal policies.

12. *May an appraisal be readdressed to a regulated institution from the borrower or another institution?*

Answer: A regulated institution cannot accept an appraisal that has been readdressed or altered by the appraiser with the intent to conceal that the original client was the borrower. Readdressing appraisals to conceal the original client, whether the client is a borrower or another financial services institution, is misleading and violates the agencies' regulations and USPAP.

13. *May an appraisal be routed from one lender to a regulated institution via the borrower?*

Answer: A regulated institution cannot accept an appraisal from the borrower unless the regulated institution can confirm that the appraisal was in fact ordered by another regulated institution or financial services institution. In accepting the appraisal, the regulated institution must also confirm that the appraiser is independent of the transaction and that the appraisal conforms to the agencies' appraisal regulations and is otherwise acceptable.

14. Can a borrower pay the appraiser directly for an appraisal that is ordered by the lender?

Answer: Since the regulated institution has engaged the appraiser for its services, the regulated institution should be the party to remit payment to the appraiser. The regulated institution may seek reimbursement from the borrower for the cost of the appraisal. However, the borrower may not recommend an appraiser to the institution or select the appraiser.

15. Can an appraiser deliver an appraisal report to more than one lender assuming the appraisal has been ordered by one of the lenders?

Answer: The agencies' appraisal regulations do not address whether an appraiser can deliver an appraisal report to more than one lender. The case may depend upon the provisions of the engagement letter. For example, the lender may specify in the engagement letter that the appraisal may be provided to another financial institution if the lender decides not to go forward on the loan. In the case of a syndicated loan, a lead lender is usually responsible for engaging the appraiser and providing copies of the appraisal to the other participating financial institutions. With regard to standards of confidentiality, USPAP directs an appraiser to be aware of, and comply with, all confidentiality and privacy laws and regulations applicable in an assignment.

16. Can the regulated institution accept an appraisal prepared by an appraiser who is a family member of the loan broker who engaged him/her?

Answer: The agencies' appraisal regulations do not address family relationships between the appraiser and the person who engages the appraiser. However, the agencies' appraisal regulations do not permit a regulated institution to accept an appraisal in which the appraiser has a direct or indirect interest, financial or otherwise, in the property or the transaction. Therefore, the regulated institution should review appraisals where a potential conflict of independence may exist and should accept the appraisal only if it can determine that the appraiser is independent of the transaction.

17. Can the regulated institution accept an appraisal prepared by an appraiser who is engaged by a financial services institution with whom the appraiser has an affiliated business relationship?

Answer: The business relationship between the financial services institution and the appraiser may not necessarily violate the independence requirement of the agencies' appraisal regulations. However, the agencies' appraisal regulations do not permit a regulated institution to accept an appraisal in which the appraiser has a direct or indirect interest, financial or otherwise, in the property or the transaction. The regulated institution should evaluate the financial services institution's controls to ensure independence and that there is appropriate separation of responsibilities and reporting lines between the appraiser and the financial services institution's lending function.

18. *How can a regulated institution ensure appraiser independence when accepting an appraisal prepared for a financial services institution?*

Answer: Documentation (that is, an engagement letter) should be available to indicate that the financial services institution (not the borrower) ordered the appraisal and that the appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction. The original lender's engagement letter to the appraiser should be made part of the appraisal report to provide additional information on the identity of the client in order to ensure independence in the appraisal process.

REVIEWING APPRAISALS

19. *Should all appraisals undergo a compliance review?*

Answer: Yes, prior to a final credit decision, regulated institutions should perform a compliance review on all appraisals to confirm that they comply with the minimum appraisal standards as outlined in the agencies' appraisal regulations, the interagency guidelines, and the independence statement. Loan administration files should document this compliance review, which may be in checklist or narrative format. In addition, certain appraisals should be reviewed more comprehensively to assess the technical quality of the appraiser's analysis prior to making a final credit decision. The regulated institution should establish guidelines for a more detailed, technical review based on transaction risk, transaction size, or other criteria. (See "Program Compliance" in the interagency guidelines.)

20. *Can a regulated institution approve a loan subject to receipt and review of an appraisal, or must the appraisal be obtained and reviewed prior to making the final decision?*

Answer: A regulated institution may grant conditional approvals to prospective borrowers before obtaining an appraisal. However, a final credit decision or action should only occur after the regulated institution receives, reviews, and accepts the appraisal.

21. *What qualifications would constitute a "qualified and adequately trained individual" for the purpose of conducting appraisal reviews?*

Answer: Individuals who review appraisals as part of a regulated institution's internal compliance function should be independent of the transaction and possess the requisite education, expertise, and competence to perform the review commensurate with the complexity of the transaction.

EVALUATION AND OTHER APPRAISAL TOPICS

22. *Can an otherwise qualified individual prepare an evaluation of a property securing a loan that will be approved by his/her direct supervisor? Can one officer perform an evaluation for another if they are both members of a loan committee, provided the evaluating officer abstains from voting? Could the lending officer or branch manager in a small, regulated institution perform the evaluation if he/she abstains from the final loan approval?*

Answer: To maintain independence, the individual preparing an evaluation should not directly report to someone involved in loan production. In a small, regulated institution where absolute lines of independence cannot be achieved, one officer may perform an evaluation for another as long as the evaluating officer abstains from the lending decision.

23. *Do the interagency guidelines apply only to loans in excess of \$250,000? Is the \$250,000 threshold the loan amount or the property value?*

Answer: The interagency guidelines apply to all real-estate-related financial transactions regardless of size or whether loans are for a regulated institution's own portfolio, held for sale, or held in asset-backed conduits. However, the agencies' appraisal regulations allow regulated institutions to use an appropriate evaluation of the real estate in lieu of an appraisal for transactions with a value of \$250,000 or less, business loans \$1 million or less, or subsequent transactions (transactions involving an existing extension of credit at the lending institution). The regulations define transaction value as the amount of the loan or extension of credit, not the value of the property. The interagency guidelines contain minimum standards for evaluation content and address the qualifications of individuals performing evaluations.

[Note: NCUA's business loan evaluation threshold is \$250,000 or less. (12 CFR Part 722.3(b)(2)]

24. *Should a regulated institution comply with the independence requirements if an appraisal is not required by the agencies' appraisal regulations?*

Answer: A regulated institution should ensure independence in the ordering process for an appraisal even if the appraisal was not required under the agencies' appraisal regulations. Regulated institutions should also maintain independence for evaluations.

25. *Does a tax-assessment value from the local taxing authority constitute an evaluation? Can a loan officer who approves and/or recommends a loan conduct an evaluation if the market value that the officer develops in the evaluation does not exceed the tax-assessment value?*

Answer: A value from the taxing authority alone is insufficient to be considered an evaluation. An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. If tax assessment information is used as part of an evaluation, the regulated institution should document the facts and analysis used to demonstrate that there is a valid correlation between the assessed values of the taxing authority and the property's market value. In addition, an evaluation should describe the real estate collateral, its condition, and its current and projected use.

A regulated institution should ensure that an individual who performs an evaluation is independent of the loan production function. Simply restricting the size of a transaction to less than the tax-assessed value alone does not comply with the agencies' appraisal regulations or the interagency guidelines, which address standards of independence. (See "Independence of the Appraisal and Evaluation Function" in the interagency guidelines.)

26. The work-out plan on a \$5 million problem loan calls for a regulated institution to receive an assignment of a \$2 million note from the borrower's relative secured by a deed of trust on a different property. Is this financial transaction considered real-estate-related and is an appraisal required on the collateral property?

Answer: Yes, this is considered a real-estate-related financial transaction. The agencies' appraisal regulations and interagency guidelines allow for an evaluation in lieu of an appraisal on new real estate collateral in certain loan workout situations depending on loan quality, collateral quality, and validity of an existing appraisal or evaluation. (See "Renewals, Refinancings and Other Subsequent Transactions" in the interagency guidelines.)

27. What is the useful life of an appraisal?

Answer: The useful life of an appraisal varies with market conditions and property type. The agencies allow a regulated institution to use an existing appraisal to support a subsequent transaction if the institution documents that the existing value estimate remains valid. Factors which could impact the value include the passage of time; the volatility of the local market; the availability of financing; the inventory of competing properties; improvements to, or lack of maintenance of, the subject property or competing surrounding properties; changes in zoning; or environmental contamination. (See "Valid Appraisals and Evaluations" in the interagency guidelines.)

28. Can a regulated institution advance new funds without a new appraisal if the value of the total loan continues to be supported by an existing appraisal and is consistent with supervisory LTV limits? Does the age of the appraisal matter if the physical condition of the property and the market conditions have not changed?

Answer: A regulated institution may use an existing appraisal or evaluation to support a subsequent transaction, as long as the credit file documents the facts and analysis that support the institution's conclusion that the appraisal or evaluation remains valid. Criteria for determining whether an existing appraisal or evaluation remains valid will vary depending upon the condition of the property and the marketplace and the nature of any subsequent transaction.

Answers to Quiz Questions: (from Chapter 4)

1. Those subject to FIRREA and those that are exempt from FIRREA (evaluations).
2. That a transaction amount greater than \$250,000 (de minimis level) is typically subject to FIRREA.
3. FIRREA.
4. Assignments that are subject to FIRREA require a more extensive description of the property than does USPAP. The simplest approach is to include a copy of the deed with the report. This is not required for evaluations.
5. Yes, but regulators caution lenders to be careful when relying on a limited appraisal.
6. Yes, it is seldom appropriate for assignments subject to FIRREA, but often very suitable for evaluations.
7. That a "limited" appraisal is always less reliable than a "complete" appraisal.
8. No specific limiting conditions or general assumptions are required. There is a requirement that all federally related transactions conform to the current USPAP.
9. The regulator's requirements are stricter. The appraiser may not have an interest in the property being appraised. USPAP allows the appraiser to have an interest as long as this interest does not result in the appraiser having bias.
10. No, FIRREA requires that the property be appraised on the assumption of "one purchaser". The appraiser must consider that this purchaser will base his offer price considering various holding costs, require a profit, and possibly discount the expected cash flow. Under these conditions the appraiser over-valued this property and did not conform to the applicable supplemental standards.
11. Yes, however the appraiser must upgrade the regulator's requirements to meet minimum USPAP standards. See "Understanding Limited Appraisals and Appraisal Reporting Options", by Stephanie Coleman, MAI, SRA, and Joseph L. Minnich III, SRPA, SRA, Appraisal Institute 1996. This book demonstrates how the appraiser can perform evaluations that conform to USPAP.

12. No, see Question 14 of the Frequently Asked Questions 3/22/05 presented above.
13. Yes, see Question 16 of the Frequently Asked Questions 3/22/05 presented above.
14. No, the value opinion must be formed for market value, which means a highest and best use analysis must be made. The value in use may be included as extra information.

ADDENDA (B) “PLANNING THE APPRAISAL OUTLINE”

I. Diagnose the Problem

A. Identify the Problem

1. Identify the Intended Use
2. Identify the Intended User(s)
 - a) Recognize the identity/class
 - b) Recognize if an individual or an entity
 - c) Determine the level of expertise
 - d) Determine the risk tolerance

B. Forces Impacting the Assignment

1. Evaluate Assignment Conditions
 - a) Contracts or Agreements with the Client
2. Recognize applicable bodies of authority
 - a) Organizations that set Professional Appraisal Standards
 - b) Organizations that set Supplemental Standards
 - c) Appraisal Commissions that enforce Laws/Rules other than USPAP
 - d) Legislatures that make Civil Laws

II. Develop a solution (Identify Pertinent Information)

- A. Type of Value
- B. Definition & Source of Value
- C. Interest (Specific Rights) Appraised
- D. Effective Date of the opinions and conclusions
- E. Are any Extraordinary Assumptions Necessary?
- F. Are any Hypothetical Conditions Necessary?

III. Assess the Due Diligence

- A. Determine effect of appraisal risk on the intended user's welfare
 1. Assess the significance of the pertinent information to the problem.
 2. Assess the significance of the problem to the intended user.
 3. Assess the effect of the appraisal risk on the intended user's position.
 4. Assess the intended user's risk tolerance.
- B. Other Input
 1. Client
 2. Applicable Bodies of Authority
 3. Appraiser's Peers
 4. Expectations of typical user
 5. Assess the Market Risk

IV. Form an Opinion of the appropriate SOW

A. Considerations

- 1. Due Diligence Requirements**
- 2. Subject Property Complexity**
- 3. Market Complexity**
- 4. Client Input**
 - a) Identify any tasks specified by contract or agreement?**
 - i. Engagement Letter**
 - ii. Bank Policies**
 - iii. Verbal Communications**
- 5. Recognize Forces Impacting the Assignment**
 - a) Recognize any specific Professional Appraisal Standards that Apply**
 - i. International**
 - ii. USPAP**
 - iii. Appraisal Organizations**
 - iiii. State Laws enforced by State Appraisal Commissions**
 - b) Recognize any specific Supplemental Standards that Apply**
 - i. Federal Banking Regulations**
 - ii. Secondary Market**
 - iii. Federal Housing Authority (FHA)**
 - iiii. Civil Laws**
 - iiiii. Client Specific Standards**
 - c) Recognize any specific directions in Appraisal Commission Laws or Rules**

B. Engineer the Analysis Specifications

- 1. Identify Analysis Necessary**
- 2. Extent (Breadth)**
- 3. Intensity (Depth)**
- 4. Competency level (Who will Perform)**

C. Engineer the Data Gathering Specifications

- 1. Type of Data**
- 2. Extent (Breadth)**
 - a) Geographical**
 - b) Sources**
- 3. Intensity (Depth)**
 - a) Volume**
 - b) Verification**
- 4. Competency Level (Who will Perform)**

D. Test the SOW for Reasonableness

V. Communicate the SOW

ADDENDA (C) SAMPLE PHRASES

Purpose

Market Value	The purpose of this appraisal is to form an opinion of Market Value.
Fair Mkt Val	The purpose of this appraisal is to form an opinion of Fair Market Value.
Replacement Cost	The purpose of this appraisal is to form an opinion of replacement cost.
Market Rent	The purpose of this appraisal is to form an opinion of market rent.
Value in Use	The purpose of this appraisal is to form an opinion of value in use.

Use

Buy or Sell Decision	The intended use is to provide information for making a buy or sell pricing decision. Market Value has a specific definition which relates to general market forces. Offers to buy or sell are often based on the individual's particular situation, and are not considered in this analysis. The intended users should consider these forces when making their decisions. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Tax break (Donation)	The intended use is to provide information for income tax calculation. The subject property is being donated to a tax exempt entity. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.

Preliminary	The intended use is to provide information for the client to make a decision on whether or not to pursue a mortgage loan. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
FHA	The intended uses are 1) to provide information for a mortgage underwriting decision, and 2) making a decision concerning mortgage insurance.
REO 30 day requirement	The intended use is to provide information as required by Federal Banking Regulations (requires an REO to be appraised within 30 days of foreclosure). This appraisal and report may be inappropriate for other uses and jeopardize the user. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Relocation	The intended use is to provide information for making an offering for a relocation company. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Mortgage	The intended use is for mortgage underwriting. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.

Foreclosure	The intended use is to provide information for a foreclosure decision. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Estate Planning	The intended use is to provide information for estate planning. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Inheritance Tax	The intended use is to provide information for inheritance tax to be based. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.
Divorce	The intended use is to provide information for property settlement. The scope of work in this appraisal is customized for the intended use. This appraisal and report may be inappropriate for other uses and jeopardize the user. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on for any use except the stated use. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any other use.

Client/Intended User

Set Offering Price	The client is Mr. Homeowner. The intended user is the herein stated client ONLY! The scope of work in this appraisal is customized for the intended user. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.
Lender/Lender	The client is the Lender. Regardless of who pays for this appraisal the intended user is the Lender ONLY. The scope of work in this appraisal is customized for the intended user. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.
FHA	The client is the Lender. Regardless of who pays for this appraisal the intended user is the Lender and the Housing and Urban Development (HUD). The scope of work in this appraisal is customized for the intended users. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.
Foreclosure	The client is XXX Bank. The intended user is the herein stated Client ONLY. The scope of work in this appraisal is customized for the intended user. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.

Estate Planning	The client is XXX Accountants. The intended user is the herein stated client and (the taxpayer). The scope of work in this appraisal is customized for the intended user. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.
Divorce	The client is the (attorney company). The intended user is the herein stated client, (who client represents), and the presiding judge. The scope of work in this appraisal is customized for the intended user. This appraisal and report may be inappropriate for other users and put them in jeopardy. Therefore, regardless of the means of possession of this report, this appraisal may not be used or relied on by anyone other than the herein stated intended user. The appraiser, appraiser's firm, and related parties assume no obligation, liability, or accountability for any third party.

Competency

Geographical	This is a market that the appraiser is unfamiliar with. I was advised by a local appraiser during the appraisal. Also, I interviewed Realtors in the area. This allowed me to reach a level of competency with the market area prior to completion of the appraisal.
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Procurement

List fee	A fee of \$150.00 was paid to be placed on this AMC's list to receive appraisals.
Kickback	The lender was paid \$25.00 for procurement of this assignment.

Previous sale

Part of Raw tract	The subject previously sold as part of a large raw tract of land. This is not considered in the valuation process. The xxx has affirmed that the sale is an arms length transaction where no seller concessions were made. No other sales of this property were found in three years previous to the effective date of this appraisal.
Not Consid- foreclosure	The subject sold for \$89,400 on 4/3/03. This sale is not considered because it was a foreclosure situation. No other sales of this property were found in three years previous to the effective date of this appraisal.

Considered	The subject sold for \$xxx on xx/xx/xx. This information is considered in the valuation process. The xxx has affirmed that the sale is an arms length transaction where no seller concessions were made. No other sales of this property were found in three years previous to the effective date of this appraisal.
Considered-Site only	The subject site sold for \$121,000 on 10/10/02. This information is considered in the current valuation of the site. The xxx has affirmed that the sale is an arms length transaction where no seller concessions were made. No other sales of this property were found in three years previous to the effective date of this appraisal.
Not Considered-Land	The subject site sold for \$50,000 on 7/16/99. This sale is not considered because it only included the subject's site. No other sales of this property were found in three years previous to the effective date of this appraisal.
Not considered-time	The subject sold for \$xxx on xx/xx/xx. This sale is not considered because the market has significantly changed since that time. No other sales of this property were found in three years previous to the effective date of this appraisal.
Not considered Remodeled	The subject sold for \$xxx on xx/xx/xx. This sale is not considered because the property has been extensively remodeled since that sale. No other sales of this property were found in three years previous to the effective date of this appraisal.
Not Sold	Research of the applicable public records, private data services, and an interview with the current owner, revealed that the subject property is not under current agreement or option and is not offered for sale on the open market. (Copied from USPAP 2005, AO-1)

Privacy

Not Provide	Privacy statement: In compliance with the Gram-Leach-Bliley Act, the appraiser will not provide any nonpublic personal information to any person or entity where that information will be used for solicitation purposes. This information may be shared among parties to process and service the consumer's transaction.
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Certificate Inspection

DAB Int & Ext	I, David Braun, did personally make a visual inventory of the subject property from the interior and exterior of the subject property.
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DAB Curbside	I, David Braun, did personally made a visual inventory of the subject property from the curbside in conjunction with this appraisal.
DAB- Vacant Land	I, David Braun, did personally make a visual inventory of the subject property while walking over the land.
DAB Site, plans, Specs	I, David Braun, did personally walk over the site and examined the plans and specifications provided to me in conjunction with this appraisal.
DAB- None	I, David Braun, did not make a visual inventory of the subject property in conjunction with this appraisal.

Contract, Listing, Option

Just Listed	The property has been listed for \$159,000 for the past 10 days. This does not provide any valuable information and is not considered in the valuation process.
Contract-Considered	There is currently a contract on the subject for \$xxx. This is considered in the valuation process.
Listing considered	The property has been listed for \$xxx for the past x months. This is considered in the valuation process.
Not Listed	Research of the applicable public records, private data services, and an interview with the current owner, revealed that the subject property has not been transferred during the past three years. (Copied from USPAP 2005, AO-1)

Organization

AI Designated	The reported analyses, opinions, and conclusions were developed, and this report has been prepared , in conformity with the requirements of the Code of Professional Ethics and Standards of Professional Appraisal Practice of the Appraisal Institute, which include the Uniform Standards of Professional Appraisal Practice. The use of this report is subject to the requirements of the Appraisal Institute relating to review by its duly authorized representatives. As of the date of this report, I David A. Braun, have completed the continuing education program of the Appraisal Institute.
AI Non Designated	The reported analyses, opinions, and conclusions were developed, and this report has been prepared , in conformity with the requirements of the Code of Professional Ethics and Standards of Professional Appraisal Practice of the Appraisal Institute, which include the Uniform Standards of Professional Appraisal Practice. The use of this report is subject to the requirements of the Appraisal Institute relating to review by its duly authorized representatives.

Hypothetical Conditions	
Omit second house	This appraisal is subject to the hypothetical condition that the smaller guest home does not exist. This is omitted in order to save on appraisal fees. The use of this condition might have affected the assignment results.
Repairs	This appraisal is subject to the hypothetical condition that the new roof is put on. This is so the borrower can borrow the funds to make the improvements. The use of this condition might have affected the assignment results.
As-if Complete	This appraisal is subject to the hypothetical condition that the proposed improvements are complete. This is so the borrower can borrow the funds to build the improvements. The use of this condition might have affected the assignment results.
S/D complete	This appraisal is subject to the hypothetical condition that the lots are complete and ready to be built on. This is so the borrower can borrow the funds to make the improvements. The use of this condition might have affected the assignment results.
Mold Clean up	This appraisal is subject to the hypothetical condition that the fungus has been removed. This condition is made so the intended user can determine if he wishes to continue with the intended use of the appraisal. The value opinion is contingent upon the mold being removed. The use of this condition might have affected the assignment results.

Extraordinary Assumptions	
Part of	This appraisal covers only a portion of the property that is currently described by public record sources. At this time no formal survey describing this division has been provided to the appraiser. This appraisal is contingent upon the extraordinary assumption that either (1 the trust note include the entire tract as described by public records, or (2 the trust note include the same property described in this appraisal report including a legal and physical means of ingress and egress. In the case of number 2, the appraiser assumes that the property described in the trust note can be legally subdivided from the whole tract in such a way that it can be foreclosed upon. The use of these assumptions might have affected the assignment results.

Curbside	This appraisal is based on the extraordinary assumption that the interior of the property is the same as described in this report. The client ordered a curbside inspection. The appraiser has gathered information about the subject property by limited visual, public records, and assumes that the interior is typical to other competing properties. Use of this report indicates that the user will not hold the valuator or the appraisal firm responsible for any damages associated with this type of data gathering method. The effect on the final value Opinion is not known.
Septic Seepage	This appraisal is based on the extraordinary assumption that the septic seepage to the surface of the ground is correctable and that there is no significant cost to correct the problem. The appraiser has no reason to believe otherwise. The use of this assumption might have affected the assignment results.
Synthetic Stucco Sid	This appraisal is based on the extraordinary assumption that the synthetic stucco siding has been properly installed and there is no water or hidden damage behind the siding. This assumption is made because there have been numerous cases of water damage in conjunction with similar types of siding in the South East. However, no signs of problems were observed when the on-site inventory was made. This is made to alert the intended users that they may want to engage in further study of the issue. The use of this assumption might have affected the assignment results.
MH Real property	This appraisal is based on the extraordinary assumption that the mobile home is real property. The access to the crawl space was locked, but the foundation appeared to be metal skirting around block piers. The appraiser has no reason to believe otherwise, but the title to the mobile home should be secured. The use of this assumption might have affected the assignment results.
Workman like manner	This appraisal is based on the extraordinary assumption that the proposed improvements will be completed in acceptable manner. The appraiser has no reason to believe otherwise. The use of this assumption might have affected the assignment results.
Proposed S/D perks	This appraisal is based on the extraordinary assumption that the property will meet the septic requirements. The appraiser has no reason to believe otherwise. The use of this assumption might have affected the assignment results.

Desktop	This appraisal is based on the extraordinary assumption that the property is the same as described in this report. The client ordered a desktop which consists of research and assumptions. The appraiser has gathered information about the subject property from one or more of the following methods; public records, interviews, or previous inspection. It is assumed that that the property is typical to other competing properties. Use of this report indicates that the user will not hold the valuator or the appraisal firm responsible for any damages associated with this type of data gathering method. The use of this assumption might have affected the assignment results.
Mold (remove)	This appraisal is based on the extraordinary assumption that the fungus does not reappear and pose a future threat to the inhabitants or the structure. This is made to alert the intended users that this is a possibility and that the appraiser recommends that they engage in further study of the issue. The use of this assumption might have affected the assignment results.
Mold (Not removed)	This appraisal is based on the extraordinary assumption that the fungus does not pose a threat to the inhabitants or the structure. This is made to alert the intended users that this is a possibility and that the appraiser recommends that they engage in further study of the issue. The use of this assumption might have affected the assignment results.

Cost Approach

Did Cost	The cost approach was performed by adding the cost new of the improvements less accrued depreciation to the site value. The opinion of the cost new of improvements was formed either by referencing a nationally recognized cost manual, the appraiser's first hand knowledge of the market, or a combination of both. The opinion of the site value was formed by a comparison of the subject to other similar properties that have a marketing history. The physical depreciation was estimated by the Age/Life method.
Not Necessary	The Cost Approach is not necessary to produce a credible appraisal. The client has requested that this approach not be performed. This omission constitutes a departure from USPAP.
No Mobile home	The Cost Approach was not performed because the cost new of a factory built home is difficult to estimate, and the accrued depreciation is difficult to measure. This approach might tend to indicate an unreliable value. This omission does not constitute a departure from USPAP.

Subdivision Development	The cost approach was performed by adding the development costs to the value of the raw land. The opinion of the development costs was formed either by referencing a nationally recognized cost manual, the appraiser's first hand knowledge of the market, the actual cost bid, or a combination of all three. The opinion of the raw land value was formed by a comparison of the subject to other similar properties that have a marketing history.
Land	The cost approach does not apply to the assignment. It's omission does not constitute a departure from USPAP.
Cost N/A Site & Depr.	The Cost Approach was not performed because the site value and accrued depreciation can not accurately be measured. This approach might tend to indicate an unrealistic value. This omission does not constitute a departure from USPAP.
Cost N/A depreciation	The Cost Approach was not performed because accrued depreciation can not accurately be measured. This approach might tend to indicate an unrealistic value. This omission does not constitute a departure from USPAP.

Direct Comparison Approach

Res. did DSCA	The Direct Sales Comparison was performed by a quantitative analysis by comparing the subject to similar properties that have a recent marketing history.
Land only	The Direct Sales Comparison of land sales was performed by a quantitative analysis by comparing the subject to similar properties that have a recent marketing history.
No- Few Improvements	The Direct Sales Comparison was not performed because the improvements represent a very small portion of the value and no good sales were found. However, this approach was used in the Cost Approach to form an opinion of the land value. This does not constitute a departure from USPAP.
Market Modeling	The Direct Sales Comparison was performed by a market modeling, where the model predicts a sales price for the comparables and compares that prediction to the actual sales price. When the predicts the market behavior reasonably well it is then applied to the subject property.
Land Dev No sales	The Direct sale Comparison method was not performed because it might be misleading as no reliable sales of large groups of sites were found. Auctions often sell out large number of lots at one time, but to a variety of buyers. FIRREA standards require that the subject be valued as if sold to "one" purchaser. The omission of this approach does not constitute a departure from USPAP.

Income Approach

Owner Occupied Area	The Income Approach is not applicable, because the subject property would not typically be purchased as a rental investment. Most similar properties in the area are owner occupied. This omission does not constitute a departure from USPAP.
DCF Method	The Income Approach was performed by the "Discounted Cash Flow" method. An Opinion of the subject's anticipated cash flow (income from the leases less various costs) is discounted over the anticipated sell out period. The discount rate is the sum of general inflation, the risk free rate, and a business risk rate expected during the sellout period.
GRM	The Income Approach was performed by the "Gross Rent Multiplier" technique. An Opinion of the subjects gross rent was formed by a direct comparison of the subject to similar properties that have a rental history.
Cap & GRM	The Income Approach was performed by the "Gross Rent Multiplier" technique and the Direct Capitalization methods. An Opinion of the subjects gross rent was formed by a direct comparison of the subject to similar properties that have a rental history.
Land	The Income Approach is not applicable to vacant land that has no land lease potential.
Not Necessary	The Income Approach is not necessary to produce a credible appraisal. The client has requested that this approach not be performed. This omission constitutes a departure from USPAP.
Comm. Capitalization	The Income Approach was performed by the "Direct Capitalization" method. The anticipated net income stream is capitalized into value by division of the market capitalization rate. The necessary data is gathered from public records, multiple listing services, and office files. These data sources are considered to be reliable, but not guaranteed. The data used is often verified by additional sources, especially when inconsistencies arise. Due to lack of reliable data, portions of this process are based on the appraisers judgment, which is tempered with education and experience.
Sub Land dev	The Income Approach was performed by the "Discounted Cash Flow" method. An Opinion of the subject's anticipated cash flow (income from sales less various costs) is discounted over the anticipated sell out period. The market data was gathered from actual cash flows of similar developments. The discount rate is the sum of general inflation, the risk free rate, and a business risk rate expected during the sellout period.

Other Analysis

H & B Use	An opinion of the Highest & Best Use was formed by considering such factors as; zoning, subdivision restrictions, the subject's current and projected use, conformity to surrounding properties, etc.
Exposure Time	An opinion of exposure time (the time the subject would typically have taken to sell preceding the effective date of the appraisal) was formed by market extraction from similar properties.
Marketing Time	An opinion of anticipated marketing time (the time the subject might typically take to sell subsequent to the effective date of the appraisal) was formed by market extraction from similar properties.

Type of Report

Restricted	This is presented in a Restricted Use report format.
Summary	This is presented in a summary report format.
Complete/restricted	This is presented in a Self-contained report format.

Value Definition & Source

Gift & Estate Tax	The Fair Market Value is defined in Internal Revenue Ruling 59-60 as; A price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy or the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts. Court decisions frequently state in addition, that the hypothetical buyer and seller are assumed to be able, as well as willing, to trade and to be well informed about the property and concerning the market for such property.
Offer Price	Offering price is defined as the typical offering price that properties in the area are offered for sale. This is calculated by multiplying the ratio of offer price to final sales price times the market value opinion.

Market Fed Regs	Market Value is defined here as: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
Market Fed (Cont)	(1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and acting in what they consider their own best interests; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale. Source: OCC [12 CFR, Part 34, Subpart C-Appraisals, §34.42 Definitions (f)]
Fair Value OCC	Fair Value is defined here as: The cash price that might reasonably be anticipated in a current sale under all conditions requisite to a fair sale. A fair sale means that buyer and seller are each acting prudently, knowledgeably, and under no necessity to buy or sell -i.e., other than in a forced or liquidation sale. The appraiser should estimate the cash price that might be received upon exposure to the open market for a reasonable time, considering the property type and local market conditions.
Fair Value (Cont)	When a current sale is unlikely-i.e., when it is unlikely that the sale can be completed within 12 months-the appraiser must discount all cash flows generated by the property to obtain the estimate of fair value. These cash flows include, but are not limited to, those arising from ownership, development, operating, and sale of the property. The discount applied shall reflect the appraiser's judgment of what a prudent, knowledgeable purchaser under no necessity to buy would be willing to pay to purchase the property in a current sale. Source: The Office of the Comptroller of the Currency (12 CFR Part 34, 42F[Docket No. 90-0016])
Use Value	Use Value is defined here as: The value a specific property has for a specific use. Source: The Dictionary of Real Estate Appraisal Third Addition of the Appraisal Institute

Liquidation Value	Liquidation Value is defined here as: The most probable price which a specific interest in real property is likely to bring under all of the following conditions: 1. Consummation of a sale will occur within a severely limited future marketing period specified by the client. 2. Actual market conditions are those currently obtaining for the property interest appraised. 3. The buyer is acting prudently and knowledgeably. 4. The seller is under extreme compulsion to sell. 5. The buyer is typically motivated.
Liquidation (Cont)	6. The buyer is acting in what he or she considers his or her best interests. 7. A limited marketing effort and time will be allowed for the completion of a sale. 8. Payment will be made in cash in U.S. dollars or in terms of financial arrangements comparable thereto. 9. The price represents a normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale. Source: The Dictionary of Real Estate Appraisal Third Addition of the Appraisal Institute
Investment Value	Investment Value is defined here as: The specific value of an investment to a particular investor or class of investors based on individual investment requirements: distinguished from market value, which is impersonal and detached. Source: The Dictionary of Real Estate Appraisal Third Addition of the Appraisal Institute
Mkt Val (Legal)	MARKET VALUE is defined here as: "The price property would command in the market. State Highway Board v. Bridges, 60 Ga.App. 240, 3 S.E.2d 907, 910. The market value of an article or piece of property is the price which it might be expected to bring if offered for sale in a fair market; not the price which might be obtained on a sale at public auction or a sale forced by the necessities of the owner, but such a price as would be fixed by negotiation and mutual agreement, after ample time to find a purchaser, as between a vendor who is willing (but not compelled) to sell and a purchaser who desires to buy but is not compelled to take the particular article or piece of property.
Mkt Val (Legal) Cont.	Winnipiseogee Lake, etc., Co. V. Gilford, 67 N.H. 514, 35 A. 945; Muser v. Magone, 155 U.S. 240, 15 S.Ct. 77, 39 L.Ed. 135; Little Rock Junction Ry. V. Woodruff, 49 Ark. 381, 5 S.W. 792, 4 Am.St.Rep.51; William H. Lowe Estate Co. v. Lederer Realty Corporation, 35 R.I. 352, 86 A. 881, 883, Abb, Cas1916A, 341. Same meaning as "reasonable market value," or "fair market value." Sanders v. Pinney, 103 Wah. 162, 174 P. 471,471; Hubbell v. City of Des Moines, 166 Iowa 581, 147 N.W. 908, 910, Ann.Cas.1916E, 592." [Source Black's Law Dictionary, Revised Fourth Edition]

Assistance

None	No one provided significant real property appraisal assistance to the person(s) signing this certification.
TRF	Tim Frox (TN Registered Trainee-xxxxx) contributed in all aspects of this appraisal under David Braun's supervision. This includes all planning, data gathering, and analysis that were required to form our opinions and conclusions.

Interest

None	I have no present or prospective interest in the property that is the subject of this report and no personal interest with respect to the parties involved.
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FOOTNOTES

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- ¹ Housing and Urban Development, Valuation Analysis for Single Family One- to Four- Unit Dwellings, Directive Number: 4150.2, Section G. Scope
- ² Supervisory Insights, Vol.1, Issue 2, Winter 2004, The Importance of a Loan Policy “Tune Up”, Pg 26
- ³ Independent Appraisal and Evaluation Functions, Frequently Asked Questions on Appraisal Regulations and the Interagency Statement, March 22, 2005.
- ⁴ “Invisible Hand.” The New Dictionary of Cultural Literacy, Third Edition. Houghton Mifflin Company, 2002. Answers.com GuruNet Corp. 09 Aug. 2005.
<http://www.answers.com/topic/invisible-hand>.
- ⁵ The Appraisal Standards Board Concept Paper; The Roles of Departure and Scope of Work describe the situation as follows: on page 1, lines 19-30:
- ⁶ The Appraisal Foundation, *Concepts and Principles of USPAP- An Instructor's Application*, 2002
- ⁷ Appraisal Standards Board, *USPAP*, 2005 ed., 18 lines 593-596
- ⁸ International Valuation Standards, 6th ed., 2003, 22
- ⁹ Appraisal Standards Board, *USPAP*, 2005 ed., 7, lines 228-229
- ¹⁰ Appraisal Institute, *Code of Professional Ethics & Standards of Professional Appraisal Practice of the Appraisal Institute*, 2004 ed.
- ¹¹ Appraisal Standards Board, *USPAP's Question & Answer*, Vol. 4 April 2002
- ¹² Appraisal Standards Board, *USPAP*, 2005 ed., 7, lines 228-229
- ¹³ Appraisal Standards Board, *USPAP*, 2005 ed., 4, lines 147-153
- ¹⁴ Appraisal Standards Board, *USPAP*, 2005 ed., 18, lines 587-592
- ¹⁵ Thomas D. Boyle, MAI “USPAP-The Bottom Line: What to do, What to Write,” *The Appraisal Journal*, Volume LXXII, Number 4, Fall 2004: 324-331.
- ¹⁶ “The United States Constitution.” US Documents. GuruNet, 2005. Answers.com GuruNet Corp. 09 Aug. 2005. <http://www.answers.com/topic/he-united-states-constitution>.
- ¹⁷ www.liability.com. August 2004.
- ¹⁸ Appraisal Standards Board, *USPAP*, 2005 ed., 31, lines 1041-1042
- ¹⁹ Appraisal Standards Board, *USPAP*, 2005 ed., 31, lines 1037 and 1038
- ²⁰ Appraisal Standards Board, *USPAP*, 2005 ed., 5, line 161-163
- ²¹ Appraisal Standards Board, *USPAP*, 2005 ed., 20, lines 480-481
- ²² Appraisal Standards Board, *USPAP*, 2005 ed., 15, lines 487-493
- ²³ “From the Examiner’s Desk... A focus on the Appraisal Referral Process”, Supervisory Insights, Vol. 1, Issue 2, Winter 2004.
- ²⁴ Appraisal Standards Board, *USPAP*, 2005 ed., 7, lines 251-252
- ²⁵ Appraisal Standards Board, *USPAP*, 2005 ed., 12, lines 412-413
- ²⁶ Appraisal Standards Board, *USPAP*, 2005 ed., 7, lines 249-250
- ²⁷ Appraisal Standards Board, *USPAP*, 2005 ed., 18, lines 597-599
- ²⁸ Appraisal Standards Board, *USPAP*, 2005 ed., 7, lines 259-261
- ²⁹ Appraisal Standards Board, *USPAP*, 2005 ed., 1, on lines 10-12
- ³⁰ Appraisal Standards Board, *USPAP*, 2005 ed., 2, lines 66-67
- ³¹ Appraisal Standards Board, *USPAP*, 2005 ed., 3, lines 104-106
- ³² Appraisal Standards Board, *USPAP*, 2005 ed., 3, lines 101-103
- ³³ Black’s Legal Dictionary, 4th ed. (West Publishing Co. 1968)
- ³⁴ Appraisal Standards Board, *USPAP*, 2005 ed., 5, lines 169-170
- ³⁵ Appraisal Standards Board, *USPAP*, 2005 ed., 107, lines 3589-3590
- ³⁶ Appraisal Standards Board, *USPAP*, 2005 ed., 107, lines 3627-3629
- ³⁷ Appraisal Standards Board, *USPAP*, 2005 ed., 4, lines 147-153
- ³⁸ The Appraisal Foundation, *Concepts and Principles of USPAP- An Instructor's Application*, 2002
- ³⁹ Appraisal Standards Board, *USPAP*, 2005 ed., 16, lines 496-498
- ⁴⁰ Appraisal Standards Board, *USPAP*, 2005 ed., 18, lines 597-599
- ⁴¹ *USPAP, Frequently Asked Questions*, 2005 ed., 74

⁴² Appraisal Standards Board, *USPAP*, 2005 ed., 24, lines 799-800 and 27, lines 901-902