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APPRAISAL REVIEW: PROCESS VS. TECHNICAL KNOWLEDGE

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Introduction – Importance of Understanding the Review Process

- Appraisal reviews are increasing in importance and frequency
 - Reviews of appraisals prepared for lending purposes
 - Litigation projects often involve review of opposing appraisal experts report
 - Financial reporting valuations typically require review by auditor and their valuation specialist as a part of completing the audit
- Available guidance on the appraisal review process is modest
 - Many assume checklists or lists of “challenging” issues reflects guidance on performing a review – this is only part of the process
- This presentation will focus on topics important to the process of performing an appraisal review. While some guidance from the financial reporting world may be presented, our intended audience is appraisers from all appraisal disciplines

Introduction – Valuation Environment

- General valuation environment and importance of reviews
 - Competitive Environment viewed as reducing quality of some valuations
 - No licensing requirements for many appraisers
 - Significant and increasing competition for work
 - These lead to downward pressure on fees and scope of work
 - Technical environment
 - Limited guidance on review process
 - Different “natures” of review (adversarial to friendly)
 - High \$ litigation – rigorous, aggressive, adversarial review
 - Lending reviews – generally collaborative, professional skepticism
 - Financial reporting reviews – generally collaborative, professional skepticism
 - Internal quality assurance review – often very collaborative

Definition of Appraisal Review (USPAP)

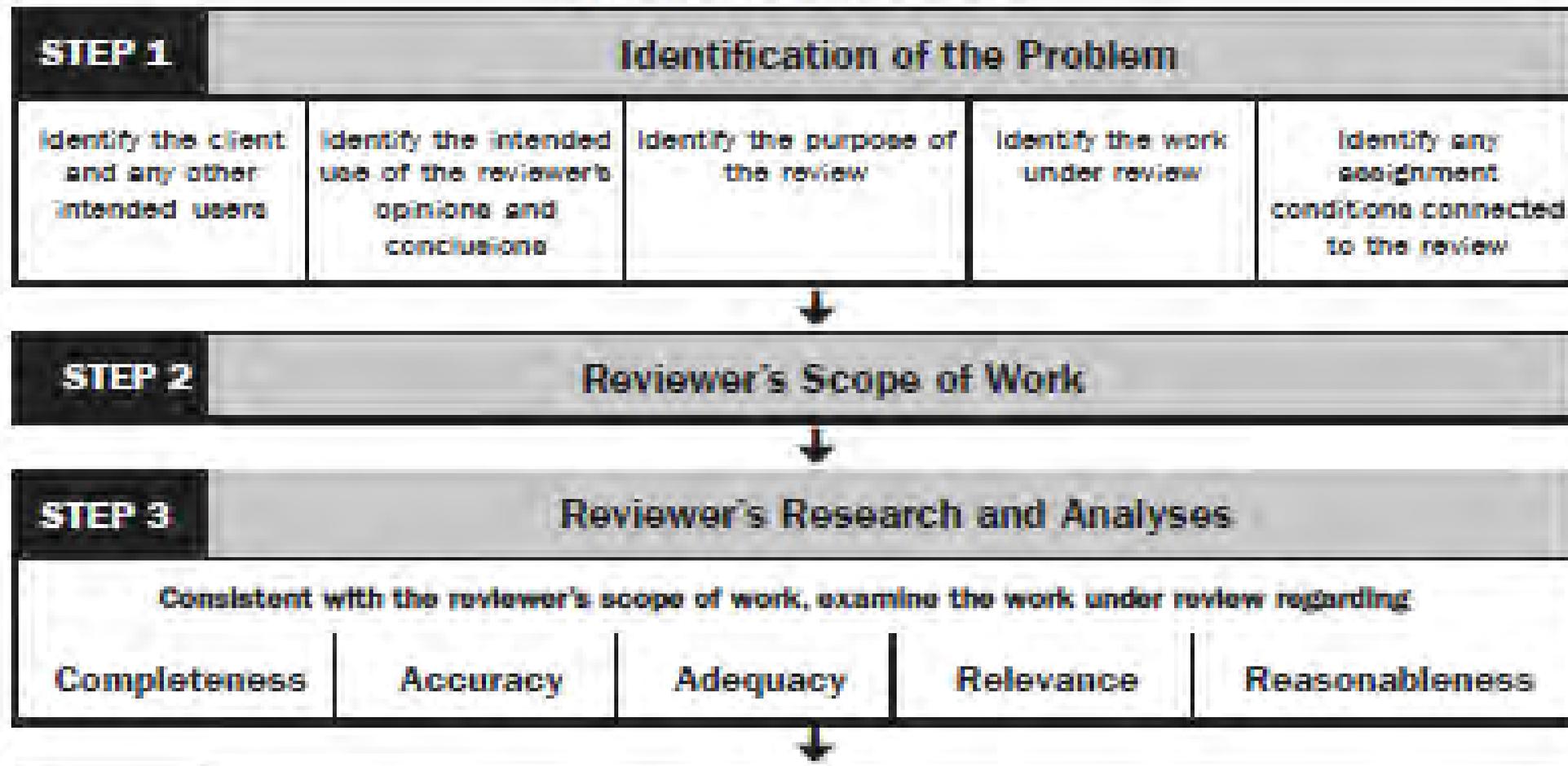
- The act or process of developing an opinion about the quality of another appraiser's work that was performed as part of an appraisal or appraisal review assignment;
- Of or pertaining to an opinion about the quality of another appraiser's work that was performed as part of an appraisal or appraisal review assignment.
 - Comment: The subject of an appraisal review assignment may be all or part of a report, work file, or a combination of these.

Materiality

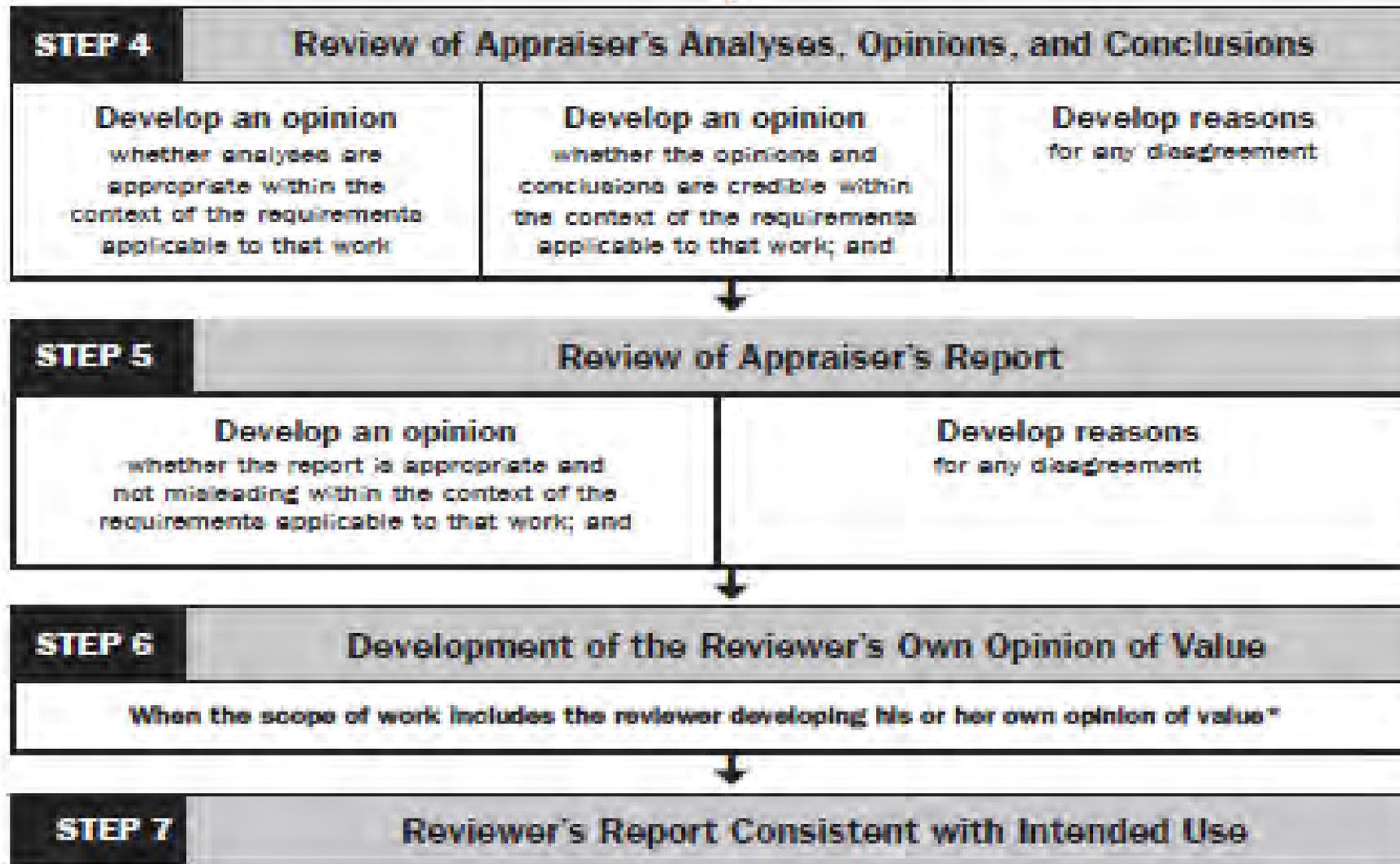
- Auditors frequently use the concept of materiality in assessing various reported items included in an audit.
- The concept of **overall materiality deals with the extent of changes** to a financial report that **would influence/change the decision of a user** of the financial report.
 - The **omission or misstatement of an item in a financial report** if the **magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed** or influenced by the inclusion or correction of the item.
- Materiality is also an important consideration for assessing appraisals when performing an appraisal review.

The Review Process – Steps 1 through 3

The Review Process



The Review Process – Steps 4 through 7



Reviewer Competence

Requirements for Competency for a Reviewer

- Competency is dependent on the reviewer's scope of work. Examples of scope:
 - Is work compliant with USPAP?
 - Obvious vs. less than obvious elements of compliance (most often technical issues)
 - Is report competently prepared?
 - Is value correct or incorrect?
 - Other
- Is reviewer competent to perform the review?
 - Sufficient technical knowledge
 - Valuation methods and assumptions
 - Specific type of asset
 - Geographic knowledge
 - Industry knowledge (for BV, RE, MTS)
 - Intended use
 - Relevant laws and regulations (financial reporting reviews require some accounting knowledge)
 - Sufficient review process knowledge
 - Sufficient knowledge of any relevant standards pertinent to the review

Scope of Work for an Appraisal Review

Issues Impacting Depth of Review Procedures

- Importance and Use of Valuation
 - a. Actual transaction – highest due diligence procedures expected
 - b. Compliance for small, immaterial transaction – more limited due diligence
 - c. Review scope influences
 - i. \$\$\$ on the table
 - ii. Risk
 - iii. Uncertainty of valuation conclusion
 - iv. Need to confirm facts
 - v. Other

Issues Impacting Depth of Review Procedures (*cont'd*)

- d. Scope of review by type of project
 - a. Transactions
 - b. Compliance
 - i. Tax –
 - a. Staff reductions at the IRS
 - b. Lottery nature of likelihood of review
 - ii. Financial reporting
 - c. Litigation - Significant review risk

Other Scope of Work Considerations

- Other scope of work considerations
 - a. Is scope of review a function of the **depth of the analysis in the Work under Review?**
 - b. Is scope of work a function of the **competence of the reviewer** which can influence the depth of review they will perform?
 - c. Is required scope of work a function of **materiality of a valuation** and the extent and sophistication of third parties that will directly rely upon or be impacted by the appraisal work product?

Scope of Review Procedures – Fair Value Hierarchy (Financial Reporting)

- Fair Value Hierarchy provides insights on the scope of review (and valuation) procedures – greater review procedures as complexity and uncertainty of valuation increases (i.e., move from Level I to Level III assets)
 - a. Level I Assets
 - i. Quoted prices in active markets for identical assets/liabilities**
 - b. Level II Assets
 - i. Observable prices for similar assets/liabilities**
 - ii. Prices for identical assets/liabilities in an inactive market**
 - c. Level III Assets
 - i. One or more unobservable inputs requiring significant judgement

What Constitutes a Review?

- Scope of procedures for a review will influence the quality of the review opinion
- **Possible elements of review**
 - Comment on credentials of appraiser preparing the appraisal
 - Confirm appropriateness of valuation with use
 - Confirm methodologies
 - Confirm assumptions
 - Check math
 - Confirm facts
- The following slides provide USPAP guidance on performing appraisal reviews.
 - Guidance is at a very high level – principles and not rules based
 - Guidance is generic and not discipline or asset specific

Scope of Work - Observations

- The Scope of Work Rule always applies to all reviews.
- An appraiser must properly identify the problem to be solved in order to determine the appropriate scope of work. The appraiser must be prepared to demonstrate that the scope of work is sufficient to produce **credible** assignment results.
- Appraisers have **broad flexibility and significant responsibility** in determining the appropriate scope of work for an appraisal or appraisal review assignment.
- The appraiser must be prepared to demonstrate that the scope of work is sufficient to produce credible assignment results.
- Credible assignment results require support by relevant evidence and logic. The credibility of assignment result is ***always measured in the context of the intended use.***
- Examples of potentially different scopes of work
 - Mature company vs. early-stage company
 - Condo in large complex vs. unique special use real estate
 - Toyota Corolla vs. Classic Ferrari

Scope of Work

- An appraiser must gather and analyze information about assignment elements that are necessary to properly identify the appraisal or appraisal review problem to be solved.
- Comment: ...identification of the problem to be solved requires the appraiser to identify the following assignment elements:
 - client and any other intended users;
 - intended use of the appraiser's opinions and conclusions;
 - type and definition of value;
 - effective date of the appraiser's opinions and conclusions;
 - subject of the assignment and its relevant characteristics; and
 - assignment conditions.
- The credibility of assignment results is always measured in the context of the intended use.

Standard of Care

■ Standard of Care

- n. the **watchfulness, attention, caution and prudence that a reasonable person in the circumstances would exercise**. If a person's actions do not meet this standard of care, then his/her acts fail to meet the duty of care which all people (supposedly) have toward others. Failure to meet the standard is negligence, and any damages resulting therefrom may be claimed in a lawsuit by the injured party. The problem is that the "standard" is often a subjective issue upon which reasonable people can differ.
- See also: duty of care, negligence
 - *Source: Law.com*

STANDARD 3: APPRAISAL REVIEW, DEVELOPMENT AND REPORTING

- **In developing an appraisal review assignment**, an appraiser acting as a reviewer must identify the problem to be solved, **determine the scope of work necessary to solve the problem**, and correctly **complete research and analyses necessary to produce a credible appraisal review**. In reporting the results of an appraisal review assignment, an appraiser acting as a reviewer must communicate each analysis, opinion, and conclusion in a manner that is not misleading.
- Standards Rule 3-1
- In developing an appraisal review, the reviewer must:
 - Be aware of, understand, and correctly employ those **methods and techniques that are necessary to produce a credible appraisal review**;
 - **Not commit a substantial error of omission or commission** that significantly affects an appraisal review; and
 - Not render appraisal review services in a careless or negligent manner, such as making a series of errors that, although individually might not significantly affect the results of an appraisal review, in the aggregate affects the credibility of those results.

Standards Rule 3-2

- **(g) determine the scope of work necessary to produce credible assignment results in accordance with the SCOPE OF WORK RULE.**
 - Comment: Reviewers have broad flexibility and significant responsibility in determining the appropriate scope of work in an appraisal review assignment.
 - Information that should have been considered by the original appraiser can be used by the reviewer in developing an opinion as to the quality of the work under review.
 - Information that was not available to the original appraiser in the normal course of business may also be used by the reviewer; however, the reviewer must not use such information in the reviewer's development of an opinion as to the quality of the work under review.

Standards Rule 3-3

- In developing an appraisal review, a reviewer must apply the appraisal review methods and techniques that are necessary for credible assignment results.
 - When necessary for credible assignment results in the review of analyses, opinions, and conclusions, the reviewer must:
 - Develop an opinion as to **whether the analyses are appropriate** within the context of the requirements applicable to that work;
 - Develop an opinion as to whether the **opinions and conclusions are credible within the context of the requirements applicable to that work**; and
 - **Develop the reasons for any disagreement.**

Standards Rule 3-4

- Each written or oral Appraisal Review Report must be separate from the work under review and must:
 - Clearly and accurately set forth the appraisal review in a manner that will not be misleading;
 - **Contain sufficient information** to enable the intended users of the appraisal review to understand the report properly; and
 - Clearly and accurately **disclose all assumptions, extraordinary assumptions, and hypothetical conditions** used in the assignment.

Confirming the Scope of the Review - Different Levels of Assurance Service

UNDERSTANDING ASSURANCE

A CPA can obtain a level of “assurance” about whether the financial statements are in accordance with the financial reporting framework. The CPA obtains assurance by obtaining evidence. There are different levels of assurance that a CPA can obtain that can range from no assurance at all, to the highest level of assurance, which is an audit. The level of assurance required by lenders is typically based on the size of the loan, the collateral and their determination of the overall risk.

Other situations that often require a level of CPA assurance include performance bonding and leasing. Certain trade creditors, outside investors or family owners that are not actively involved in the business may also request or require a level of assurance on your financial statements. If your requirements are unclear, in many cases, your CPA can speak with your lender and others about the level of service that will satisfy their requirements.

ASSURANCE



Review vs. Audit – Key Differences and Observations for Appraisal Reviews

- Objective
 - **Review** – To obtain **limited assurance** as a basis for reporting whether the CPA is aware of any material modifications . . . primarily through the performance of inquiry and analytical procedures.
 - **Audit** - To obtain **reasonable assurance** about whether the financial statements as a whole are free of material misstatement . . . in all material respects, . . .
- **Fraud risk – Not part of a review but part of an audit.**
- **Verification and substantiation procedures** – Not part of a review but part of an audit.
- The term “audit” is not used in the appraisal review world. Presumably, a comprehensive review where all needed procedures are performed would most closely “map” to an audit.
 - Do appraisal reviews include verification and substantiation procedures either by the review appraiser or by the client hiring the review appraiser or another party?
 - Do appraisal reviews include efforts to detect fraud?

Review vs. Audit - Review

- The **review service** is one in which the CPA performs analytical procedures, inquiries and other procedures to obtain “**limited assurance**” on the financial statements and is intended to provide a user with a level of comfort on their accuracy. The review is the base level of CPA assurance services.
- A review is substantially narrower in scope than an audit. **A review does not** contemplate obtaining an understanding of your business’s internal control; **assessing fraud risk**; testing accounting records through inspection, observation, outside confirmation or the **examination of source documents or other procedures** ordinarily performed in an audit.
- **Takeaway for appraisal review** – remember these important elements needed to develop the highest degree of comfort that a valuation opinion is reasonable.

Source: *Guide to Financial Statement Services: Compilation, Review and Audit* © 2015, AICPA.

Review vs. Audit - Audit

- The **audit is the highest level of assurance** service that a CPA performs and is intended to provide a user comfort on the accuracy of the financial statements. The CPA performs procedures in order to obtain “**reasonable assurance**” (defined as a **high but not absolute level of assurance**) about whether the financial statements are free from material misstatement.
- In an audit, your CPA is required to obtain an understanding of your business’s internal control and **assess fraud risk**. Your CPA is also required to corroborate the amounts and disclosures included in your financial statements by obtaining audit evidence through inquiry, physical inspection, observation, third-party confirmations, examination, analytical procedures and other procedures.
- As the highest level of assurance, an audit typically is appropriate and often required when seeking complex or high levels of financing and credit. An audit also is appropriate when seeking outside investors or preparing to sell or merge with another business.

Source: *Guide to Financial Statement Services: Compilation, Review and Audit* © 2015, AICPA.

Reviewer's Research and Analysis

Completeness, Accuracy, Adequacy, Relevance and Reasonableness

- Appraisal review theory and education specifically focus on the attributes above in developing reliable review opinions.
- Audit guidance also focuses on similar traits to develop a reasonable audit opinion.
- Technical guidance of assessing databases focuses on a variety of important attributes to insure the reasonableness of the data.

CAARR – Completeness, Accuracy, Adequacy, Relevance and Reasonableness

1. **Completeness** – comprehensive and thorough
2. **Accuracy:**
 - a. Conformity—compliance with requirements established by assignment conditions
 - b. Correctness—mistake free
 - c. Provable—Can data be retrieved and analyses replicated?
3. **Adequacy:**
 - a. Sufficient evidence acquired
4. **Relevance:**
 - a. Connected—directly or indirectly linked to the conclusion
 - b. Applicable—important to the outcome
 - c. Useful—has practical value
 - d. Significant—just shy of essential
5. **Reasonableness:**
 - a. Common sense—practical judgment, realistic, and credible
 - b. Rational—balanced and sound thinking, not excessive or extreme
 - c. Fair—impartial, objective, evenhanded, and open-minded
 - d. Acceptable—suitable

Significant Assumptions

- Significant assumptions are generally:
 - Sensitive to variation or uncertainty in amount or nature
 - Susceptible to misapplication or bias
- **In testing significant assumptions, the valuation model, and the underlying data, determine if:**
 - **Assumptions are reasonable** and reflect, or are not inconsistent with, market information
 - **Value estimate was determined using an appropriate model**
 - The data used to develop value measurements (including asset owner's data, if applicable) is **accurate, complete, and relevant information** that was reasonably available at the time

Shadow Calculations – When to Use

- Benefits associated with the use of shadow calculations include:
 - Can reduce review time associated with the math check of complex models
 - Allows ease of testing alternative assumptions and developing sensitivity analyses
 - Decreases detection risk
- Shadow calculations should be performed when:
 - Disagree with methodology / assumption
 - Complex analysis
 - Quality of valuation provider is a concern
 - Change in methodology / assumptions from a prior analysis (i.e. goodwill impairment testing)

Evidence – Comments from Auditing Guidance

- Sufficient Appropriate Audit Evidence
- **.06** *Sufficiency* is the measure of the quantity of audit evidence. *Appropriateness* is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions. The auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less the audit evidence that may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate if it is of a lower quality.

Evidence – Cost vs. Benefit Consideration

- **.12** The auditor may consider the relationship between the **cost** of obtaining audit evidence and the **usefulness** of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an audit procedure for which there is no appropriate alternative.
- **.13** In forming the audit opinion, the auditor does not examine all the information available (evidence) because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor may find it necessary to **rely on audit evidence that is persuasive rather than conclusive**; however, to obtain reasonable assurance, the auditor **must not be satisfied with audit evidence that is less than persuasive**. The auditor should use professional judgment and should exercise professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit opinion.

Inquiry – Likely Insufficient Review Procedure in Certain Instances

- **.31** Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, inside or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.
- **.32** Inquiry normally involves:
 - Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned.
 - Asking clear, concise, and relevant questions.
 - Using open or closed questions appropriately.
 - Listening actively and effectively.
 - Considering the reactions and responses and asking follow-up questions.
 - Evaluating the response.
- **.33** In some cases, the auditor should obtain replies to inquiries in the form of written representations from management.

Inquiry

- **.35** The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.
- **.36** Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management's intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

Confirmation

- **.37** Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. A confirmation request can be designed to ask if any modifications have been made to the agreement, and if so, what the relevant details are. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of an undisclosed agreement that may influence revenue recognition. See section 330, *The Confirmation Process*, for further guidance on confirmations.

Recalculation

- **.38** Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

Reviewer's Opinion of Value

Options for Providing the Reviewer's Opinion of Value

1. Possible appraisal review opinions include:
 - a. Insufficient information included in the report to assess reasonableness of conclusion
 - b. Specific opinions on value conclusion
 1. Concurrence
 2. Concurrence with reservation – inclusion of a hypothetical condition pertaining to the Work under Review
 3. Disagreement
 4. Disagreement and providing an alternative value opinion
 - i. Point estimate
 - ii. Range of Value
 - iii. General relationship of appropriate value to that stated – i.e., higher or lower

Reviewer's Report

Review Documentation

1. Documentation of the Review
 - a. Review deliverables include
 - i. Report with all required content
 - ii. Supporting documentation
 1. Checklists, if any
 2. Other materials gathered as a part of the review

Minimum Content for Review Reports

1. Reviewer's **client** and any **other intended users** of the review report.
2. Reviewer's **intended use** of the review.
3. **Purpose** of the review. (*Problem the review is solving or question(s) it is answering*)
4. **Subject** of the review assignment.
5. **Ownership interest of the property** that is the subject of the work under review.
6. **Date of the work under review.**
7. **Effective date of the opinions and conclusions in the work under review.**
8. Appraiser(s) who completed the work under review (if provided).

Minimum Content for Review Reports (*cont'd*)

9. Date of the review report.

10. Extraordinary assumptions and hypothetical conditions used in review and statement that their use might have affected the assignment results.

11. Reviewer's scope of work.

12. Reviewer's opinions and conclusions about the work under review, including the reasons for any disagreement.

13. When opinion of value provided, statement of information, analyses, opinions and conclusion from work under review were relied upon.

14. Signed review certification (fairly similar to appraisal certification).

Conclusion

- Appraisal reviews are receiving increasing scrutiny
- Existing guidance on the appraisal review process is modest
- Importance of full understanding of the review process is a key component of provide appraisal reviews that are
 - Meaningful and relevant to the Intended Users
 - Not misleading as to scope of work and form of opinion provided

QUESTIONS

APPENDIX

Guidance on Performing Reviews – Valuation Professional Organization Courses

- American Society of Appraisers Review Courses
 - ARM 201 – Development of a Review
 - ARM 204 – Application and Report Writing
- Appraisal Institute Review Courses
 - Review Theory: General
 - Review Case Studies: General
 - Review Theory: Residential
 - Review Case Studies: Residential
- The Appraisal Foundation (through McKissock Learning)
 - Residential Appraisal Review and USPAP Compliance
- EllieMae (lender focused technology solutions company)
 - Appraisal Review: The Framework and Appraisal Review: The Next Level

Guidance on Performing Reviews – Real Estate

- Guidance for other appraisal disciplines
 - i. *Review Theory-General*, Appraisal Institute, ©2013
 - ii. Appraisal Institute, *Scope of Work*, Second Edition ©2016 – real estate scope of work
 - iii. HUD – *Guide for Preparing An Appraisal Scope of Work* (four pages)
 1. Very brief and high level
 2. One page is a required certification

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