MEMO

Date: March 23, 2005

To: Mr. John Ross, Chief Executive Officer, Appraisal Institute
Mr. Jerry Larkins, Executive Vice President, American Society of Appraisers
Mr. Henry Long, Jr., Executive Vice President, American Society of Farm Managers and Rural Appraisers

Re: Response to March 23, 2005 letter submitted to Honorable Charles Grassley by the State of South Carolina Department of Revenue

The purpose of this memo is to respond to the March 23, 2005 letter submitted to the Honorable Charles Grassley by the State of South Carolina Department of Revenue.

Stated Concern

Page two of the letter specifically refers to a valuation tool often used by appraisers, the "subdivision development analysis" (sic), one which the letter alleges "…can be easily manipulated to provide high valuations…"

Professional Guidance

Commonly accepted sources of appraisal methodology refer to or describe the use of this valuation technique. ***The Appraisal of Real Estate, Twelfth Edition***, published by The Appraisal Institute 2001, has a portion of Chapter 13, *Land or Site Valuation*, devoted to the subject, which it calls *Subdivision Development Analysis* (pages 342 through 346). The chapter prominently places the following admonition to the use of this valuation technique:"*When used on its own without an abundance of reliable market data, it can be the least accurate raw land valuation technique."* It continues to state that *"…the value indication is most persuasive when the sales comparison method provides additional support."*

The Appraisal of Rural Property, Second Edition, published by The American Society of Farm Managers and Rural Appraisers and the Appraisal Institute, 2000, page 203, also comments on this valuation technique. It states, in part, *"This … approach is used to value land when subdivision is the highest and best use or <u>when subdivision is imminent</u> (emphasis added). In rural appraisals it is most often used when the property is in a transitional stage from agricultural uses to urban uses."* In the development of Highest and Best Use Analysis, which this text recognizes as part of the decision making process when selecting an appropriate valuation technique, it is incumbent on the appraiser to consider all legally permissible, physically possible, economically feasible, and maximally productive uses to which the property can be put. Underlying this analysis is the concept that all uses considered be reasonable, practical, and appropriately supported.

Applicable Standards

A review of appropriate standards applicable to valuation was undertaken. The Uniform Standards of Professional Appraisal Practice (USPAP"), 2005 does not specifically refer to this valuation technique. However, there is guidance provided to the appraiser as to how technique(s) should be employed in the valuation process.

USPAP Standards Rule 1-3 states:

> **When the value opinion to be developed is market value, and given the scope of work identified in accordance with Standards Rule 1-2(f), an appraiser must:**
>
> **(a) identify and analyze the effect on use and value of existing land use regulations, reasonably probable modifications of such land use regulations, economic supply and demand, the physical adaptability of the real estate, and market area trends; and**
>
> Comment: An appraiser must avoid making an unsupported assumption or premise about market area trends, effective age, and remaining life.
>
> **(b) develop an opinion of the highest and best use of the real estate.**
>
> Comment: An appraiser must analyze the relevant legal, physical, and economic factors to the extent necessary to support the appraiser's highest and best use conclusion(s).

It is clear that this Standards Rule requires the appraiser to consider several elements that are requisite to a credible subdivision analysis, including the reasonableness of the use based on existing land use regulations and probable modifications, supply and demand, market trends, and the suitability of the property to such an analysis.

Further guidance on the use of the valuation technique is provided via USPAP Statement 2. It is important to remember that Statements have the full weight of a Standards Rule.

Statement 2 was developed specifically to address the use of the Discounted Cash Flow Analysis ("DCF") as a methodology and valuation technique. The Subdivision Analysis technique is applied using the DCF.

Statement 2 contains the following statement: "*DCF analysis is an additional tool available to the appraiser and is best applied in developing value opinions in the context of one or more other approaches. This statement focuses on the criteria for proper DCF analysis and does not imply that DCF analysis is or should be the only method employed.*" (Lines 2983 through 2985, page 85, USPAP) Throughout Statement 2 the appraiser is directed to use caution when employing this technique, is cautioned as to its sensitivity to inputs (i.e. discount rates, absorption rates, yields, etc.).

The Statement goes on to advise the appraiser that "Standards Rule 1-1(b) states that the appraiser must not commit a substantial error of omission or commission that significantly affects an appraisal. Standards Rule 1-1(c) states that the appraiser must not render appraisal 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, in the aggregate would affect the credibility of those results. These two Standards Rules are significant for DCF analysis because of the potential for the compounding effect of errors in the input, unrealistic assumptions, and programming errors". (Lines 2995 through 3001, page 86, USPAP)

Standards Rule 1-4(h) requires realistic forecasts in the appraisal of proposed improvements and development projects. Standards Rule 1-4(c) (iv) requires that projections of anticipated future rent and/or income potential and expenses be based on reasonably clear and appropriate evidence. The Comment to this Standards Rule makes specific reference to cash flow projections, the essence of DCF analysis. (Lines 3006 through 2010, page 86, USPAP)

Statement 2 concludes with the following:

CONCLUSIONS:

- DCF analysis is an additional tool available to the appraiser and is best applied in developing value opinions in the context of one or more other approaches.
- It is the responsibility of the appraiser to ensure that the controlling input is consistent with market evidence and prevailing market attitudes.
- Market value DCF analyses should be supported by market-derived data and the assumptions should be both market- and property-specific.
- If using commercial software the appraiser should cite the name and version of the software and provide a brief description of the methods and assumptions inherent in the software.
- DCF accounts for and reflects those items and forces that affect the revenue, expenses, and ultimate earning capacity of real estate and represents a forecast of events that would be considered likely within a specific market.
- The results of DCF analysis should be tested and checked for errors and reasonableness.
- Standards Rule 1-1(b) states that the appraiser must not commit a substantial error of omission or commission that significantly affects an appraisal.

(Lines 3039 through 3055, page 87, USPAP)

USPAP is not the only valuation standard to recognize the sensitivity of the Subdivision Analysis technique in valuation of real property. The Uniform Appraisal Standards for Federal Land Acquisitions ("UASFLA" or "The Yellow Book") also comments on the technique.

Section A-15 of UASFLA puts forth the standards required for estimating land value. Section A-15 refers to the "Development Approach" and incorporates Section B-8 which provides significant caution as to the use of the technique. B-8 states that *"When comparable sales are available with which to accurately estimate the property's market value, the development approach should not be relied upon as the primary indicator of value, as it is considerably prone to error. However, even when adequate comparable sales are available, the development approach can be utilized to test both the highest and best use conclusion and to support the indicated value of the property by the sales comparison approach to value."*

Section D-11 of UASFLA provides further guidance on the use of DCF analysis. While this section primarily addresses mineral valuation, the caution(s) contained therein are just as applicable to the use of the Development Approach version of a DCF. Section D-11 states that *"In conducting DCF analysis, the appraiser must avoid estimating a property-specific investment value to a particular owner instead of estimating the market value of the property if it were placed for sale on the open market."*

Finally, the letter from South Carolina refers to pages 95 – 98 of its publication "**Local, State and Federal Tax Incentives for Conservation Easements, Second Edition**". This section recognizes the sensitivity of the use of the Subdivision Development technique, and puts forth cautions that are very similar to those found in professional literature, USPAP, and UASFLA.

Conclusions

It is our opinion that the concerns raised by the State of South Carolina have credibility. There are, indeed, appraisers who are using valuation techniques improperly. However, we disagree with the suggested remedy, that this can be solved by *"…restricting or banning use of the subdivision development analysis"*.

There is adequate guidance, both in professional literature and in adopted and recognized standards, with which to correct the problem. As it relates specifically to the topic at hand, that is the valuation of conservation easements used as charitable donations (indeed as to the value of all charitable donations), we have concluded the following:

1. There is a body that has been authorized by Congress as the Source of Appraisal Standards and Appraiser Qualifications – The Appraisal Foundation
2. This body has been empowered to develop standards and qualifications for appraisals and appraisers under Title XI of FIRREA
3. The professional literature that puts forth doctrine and theory provides specific guidance as to the use of the technique in question and is explicit in the technique's sensitivity to multiple inputs
4. The Uniform Standards of Professional Appraisal Practice provides specific guidance as to the requirements that must be met by appraisers using Discounted Cash Flow Analysis (the Subdivision Analysis technique is a form of DCF application)
5. Supplemental standards (UASFLA) developed by the Interagency Land Acquisition Conference contain specific guidance as to the use of the valuation technique known as Subdivision Analysis, or Development Analysis

Recommendations

1. The Congress should expand the charge of The Appraisal Foundation to include all valuations for use in connection with public funds, including those valuations used to support charitable donation value, thereby making all appraisals used by the U.S. Government subject to USPAP and all appraisers employed by the U.S. Government subject to consistent, minimum Appraiser Qualifications
2. The guidance provided in UASFLA should be required, where applicable, as a "Supplemental Standard" as defined in USPAP (There are already instances where appraisal assignments issued by government entities are required to meet both sets of standards, and to this point no significant conflict has been reported.)
3. The appropriate authorities/agencies should be instructed to adopt the accepted standard (USPAP) and minimum qualifications for appraisers that are required of the State jurisdictions under Title XI of FIRREA
4. In defining qualified appraisers for valuation of conservation easements and/or charitable donations, emphasis should be placed on minimum qualifications as promulgated by the Appraiser Qualifications Board applied in conjunction with the Competency Rule of USPAP

Sincerely,

W. David Snook, ASA Arthur E. Clapp, ARA, ASA

Transmitted electronically with signature on the paper copy retained in the author's file.