An Overview of the USPAP

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Whether they are asked to value a business, an interest or claim, or a security or intangible asset, valuation professionals are frequently retained to testify or consult across a wide variety of disputes relating to antitrust and competition policy, bankruptcy and restructuring, commercial contracts, damages, international arbitration, mergers and acquisitions, and securities, among other matters. To be effective and, in the worst case, to avoid the unpleasant consequences of a successful Daubert challenge, experts belonging to one or more of the organizations that have adopted professional standards of conduct and of how an appraisal is to be performed and reported must understand and comply with those standards, while experts not so affiliated are wise to follow the guidance provided by the standards as a model of best practices. Moreover, an awareness and understanding of valuation standards can be invaluable to counsel in selecting, working with, and supporting or opposing a valuation expert.

The development and formal codification of valuation standards used in practice today can be traced to the savings-and-loan (S&L) crisis of the 1980s. S&Ls had made loans based on property appraisals in which the appraised values greatly exceeded the values realizable against the property. When the loans defaulted, the S&Ls incurred significant losses, which, together with spiraling interest rates and the practice of financing long-term assets with short-term liabilities, contributed to the greatest failure of financial institutions since the 1930s, with 296 institutions holding $125 billion in assets being closed or resolved between 1986 and 1989, along with the insurer of the thrifts, the Federal Savings and Loan Insurance Corporation. An additional 747 thrifts holding $393 billion in assets were closed or resolved by the Resolution Trust Corporation between 1989 and 1995.

In recognition of the need to improve appraisal practices, in 1986 a group of leading professional appraisal organizations from the United States and Canada formed a committee to develop a generally accepted set of valuation standards. The standards, which address the appraisal of real estate, personal property, and businesses, were adopted by the committee members from the United States, and in 1987, the Appraisal Foundation, which includes the Appraisal Standards Board and Appraiser Qualifications Board, was established to implement what became known as the Uniform Standards of Professional Appraisal Practice (USPAP). USPAP was formally adopted by the Appraisal Standards Board on January 30, 1989, and on August 9, 1989, Congress enacted Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), under which (1) all certified appraisers must meet the Appraiser Qualifications Board's qualification criteria, (2) all state appraisal examinations must be reviewed and approved by the Appraiser Qualifications Board, and (3) all appraisals for federally related transactions must conform with USPAP.

USPAP has since been recognized throughout the United States as the generally accepted standards of professional appraisal practice that underpin valuation practice today—together with valuation standards issued by the American Society of Appraisers, Institute of Business Appraisers, American Institute of Certified Public Accountants, National Association of Certified Valuation Analysts, Association of Insolvency and Restructuring Advisors (forthcoming), Canadian Institute of Chartered Business Valuators, Royal Institution of Surveyors, International Valuation Standards Council, and the Internal Revenue Service.

And though there are differences among the standards promulgated by the various appraisal organizations, in substance they are not conflicting, and though more detailed than USPAP, they are comparable in addressing issues of ethics, competence, objectivity, independence, valuation methods, and reporting requirements. For example, members of the American Society of Appraisers are also required to comply with the standards set forth in USPAP. Accordingly, the remainder of this article will focus on USPAP and the sections therein applicable to the development and communication of an appraisal of a business or intangible asset (Standards 9 and 10).

The Ethics Rule of USPAP provides guidance with respect to conduct, management, confidentiality, and record-keeping requirements. Proper conduct requires that appraisals be prepared with impartiality, objectivity, and independence, and without regard to personal interests. Among other things, this requires that an appraiser not (1) perform an appraisal with bias, (2) advocate the cause of any party, (3) accept an engagement requiring the reporting of a predetermined result, (4) report the results of an engagement with the intent to mislead or to defraud, (5) use or convey a report that is known by the appraiser to be misleading or fraudulent, and (6) knowingly permit an employee or other person to disseminate a misleading or fraudulent report. In addition, appraisers are required to disclose any current or future interest in the subject of the appraisal or parties involved, as well as any services provided with respect to the subject of the appraisal within the three-year period preceding the engagement.

The management provisions of the Ethics Rule consider the payment or receipt of fees by the appraiser. For example, an appraiser must disclose that he or she paid a fee or otherwise gave something of value in connection with procuring an engagement. Further, an appraiser may not accept an engagement or have an arrangement where the appraiser's compensation is contingent on reporting a predetermined result, a direction in results that favors a client's cause, the amount of the value conclusion, or the occurrence of a subsequent event that is directly related to the appraiser's conclusions

and specific to the purpose of the engagement. Advertising or soliciting an engagement in a way that is false, misleading, or exaggerated is also prohibited.

The confidentiality portion of the Ethics Rule requires that an appraiser protect the confidential nature of the client relationship. Consequently, an appraiser must not disclose confidential information or the results of an engagement to anyone other than the client or persons authorized by the client except as required by due process of law or authorized peer-review committee. Appraisers are also therefore required to be aware of and comply with all confidentiality and privacy laws and regulations.

The Record Keeping section of the Ethics Rule requires that an appraiser set up a work file for each appraisal, appraisal review, or appraisal consulting engagement. Included in the work file should be the name of the client and identity of other intended users, copies of any written reports, summaries or transcripts of any oral reports or testimony, and all data, information, and documents required to support the appraiser's opinions, conclusions, and compliance with USPAP. In addition, appraisers must retain the work file for at least five years after completion of the engagement or for a minimum of two years after final resolution of any judicial proceeding in which the appraiser provided related testimony, whichever is longer.

Under the Competency Rule, an appraiser must be competent to perform the work required by the engagement, be able to acquire the level of competence necessary to perform the work required if not competent, or, in the alternative, decline or withdraw from the engagement. Within this framework, competency means that the appraiser is capable of properly identifying the problem to be resolved, has the level of knowledge and experience necessary to complete the work, and is able to recognize and comply with applicable laws and regulations. Should an appraiser find that he or she is not in fact competent, the appraiser must inform the client of his or her lack of knowledge or experience prior to accepting the engagement, take whatever actions are needed to perform the engagement competently if engaged, and note in the report his or her lack of knowledge or experience, as well as the steps taken to complete the engagement in a competent fashion. For purposes of this rule, competency can be achieved a number of ways, including through personal study by the appraiser, association with an appraiser having the necessary knowledge or experience, or retention of other professionals having the knowledge or experience required.

The Scope of Work Rule requires that an appraiser identify the problem to be solved, determine and perform the scope of work that is needed to

develop credible results, and disclose the scope of work performed in his or her report. Identification of the problem requires the appraiser to identify the client and any other users, the intended use of the appraiser's opinions and conclusions, the type and definition of value, the effective date of the appraisal, the subject of the appraisal and its relevant characteristics, and the engagement conditions (i.e., assumptions, extraordinary assumptions, hypothetical conditions, laws, regulations, and jurisdictional exceptions). Having this information enables the appraiser to determine the type and extent of research and analyses required to develop credible results. Where relevant information is not available as a consequence of limitations posed by assignment conditions that limit research opportunities (i.e., conditions that limit inspection or information gathering), an appraiser must withdraw from the engagement unless he or she is able to modify the assignment conditions to allow for gathering the information or, in the alternative, use an extraordinary assumption about the information if, in doing so, it is still possible to develop credible results. The research and analyses performed must also be disclosed in the report to allow intended users who rely on the results to understand the scope of work performed.

The Jurisdictional Exception Rule stipulates that if compliance with any part of USPAP is precluded by law or regulation, only that part of USPAP becomes void for the engagement. Faced with this situation, the appraiser must identify and comply with the law or regulation that precludes USPAP compliance, disclose the part of USPAP that is voided by the law, and cite in the report the law or regulation requiring the exception. Instructions from a client or attorney do not establish a jurisdictional exception.

Standard 9 of USPAP requires that "[i]n developing an appraisal of an interest in a business enterprise or intangible asset, an appraiser must identify the problem to be solved, determine the scope of work necessary to solve the problem, and correctly complete the research and analyses necessary to produce a credible appraisal." How these tasks are to be performed is explained in greater detail in five underlying rules.

Rule 9-1 provides general, high-level guidance stating that an appraiser must understand and correctly employ the recognized approaches, methods, and procedures required to produce a credible appraisal, not commit an error of omission or commission that would significantly affect his or her opinions and conclusions, and not provide appraisal services carelessly by making a series of errors that, while insignificant on an individual basis, undermine the results of the appraisal in aggregate.

To an extent duplicative of the Scope of Work Rule, Rule 9-2 requires an

appraiser to identify

• the client and other intended users;
• the intended use of the appraiser's opinions and conclusions;
• the standard and premise of value;
• the effective date of the appraisal;
• the characteristics of the subject relevant to the standard of value and intended use of the appraisal;
• the subject business, intangible asset, and interest therein;
• any buy-sell and option agreements, letter stock restrictions, restrictive corporate charter, or partnership agreements;
• the degree to which the interest has control;
• the degree to which the interest is marketable and liquid;
• extraordinary assumptions;
• hypothetical conditions; and
• the scope of work necessary to produce credible results.

Rule 9-3 introduces the concept of highest and best use for purposes of determining the appropriate premise of value. In developing an appraisal of an equity interest having the ability to force liquidation, an appraiser must consider whether the value of the business is greater in liquidation than in continued use as a going concern. If the value of the interest is higher in liquidation, a liquidation premise may be appropriate, and the scope of work may require the appraisal of any real or personal property to be liquidated.

Rule 9-4 requires the appraiser to analyze the historical results and future prospects of the business within the context of the economic and industry conditions in which it operates. Thus, in developing a conclusion of value, the appraiser should analyze by means of one or more valuation approaches the effect on value of

• the nature and history of the business;
• conditions affecting the business, its industry, and the economy;
• the historical and current financial results and future prospects of the business;
• previous sales of stock and other ownership interests in the business;
• sales of stock or other ownership interests in similar businesses;
• prices, terms, and conditions affecting past sales of similar ownership interests;
• the economic benefit of tangible and intangible assets;
• buy-sell and option agreements, letter stock restrictions, restrictive corporate charter, or partnership agreements; and
• the degree to which the interest has control and is marketable and or liquid.

Rule 9-5 pertains to the way in which an appraiser is to arrive at a conclusion of value. The process is a function of the appraiser's judgment, rather than a purely mathematical exercise, and requires that the appraiser reconcile the quality and quantity of data available and analyzed together with the applicability and relevance of the approaches, methods, and procedures employed.

A corollary to Standard 9, Standard 10 concerns how the results of an appraisal of an interest in a business are reported. The standard holds that an appraiser must report each analysis, opinion, and conclusion in a manner that is not misleading; however, the standard does not specify the form, format, or style of the report. Rather, its focus is on the level of information and content.

Rule 10-1 requires that a written or oral report communicate the appraisal in a way that will not be misleading, provide information sufficient to enable the intended users of the report to understand it, and clearly and accurately identify all assumptions, extraordinary assumptions, hypothetical conditions, and limiting conditions employed.

Rule 10-2 expands on Rule 10-1 by requiring that where the intended users include parties other than the client, an appraisal report must be provided (Rule 10-2(a)), while a restricted use report may be used if the intended users do not include parties other than the client (Rule 10-2 (b)). The difference between the two reports is in the content and level of information provided. Under Rule 10-2 (a), the content of an appraisal report must be consistent with the intended use of the report and include at a minimum

- the identity of the client and any other intended users;
- the intended use of the appraisal;
- the business or interest appraised;
- the degree to which the interest has control;
- the degree to which the interest lacks marketability or is illiquid;
- the standard and premise of value used, including the definition source;
- the effective date of the appraisal and report;
- the scope of work;
- the information analyzed, procedures used, and reasoning underlying the analyses, opinions, conclusions, and exclusion of any approach;
- extraordinary assumptions, hypothetical conditions, and their effect on the results; and
- signed certification required by Rule 10-3.

By comparison, the requirements for a restricted report under Rule 10-2 (b) are identical except that instead of simply identifying the client and other intended users, the report must state that its use is limited to the client and warn that information in the appraiser's work file may be necessary to a proper understanding.

Rule 10-3 requires an appraisal report to contain a certification signed by the appraiser affirming that the report was prepared in accordance with the requirements of Standard 9. By signing the certification, the appraiser accepts responsibility for the statements contained in the certification, the results of the engagement, and the contents of the appraisal report. The certification is required to include statements to the effect that

- the facts in the report are true and correct;
- the analyses, opinions, and conclusions of the report are limited only by the stated assumptions and limiting conditions;
- the appraiser has no interest in the subject of the appraisal or with respect to the parties;
- the appraiser is not biased with respect to the subject of the appraisal or to the parties;
- the engagement is not contingent on the appraiser developing or reporting a predetermined result;
- the appraiser's compensation is not contingent on developing or reporting a predetermined value, a direction in value that favors the cause of the client, the amount of the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of the appraisal;
- the analyses, opinions, and conclusions were developed, and the report was prepared, in conformance with USPAP; and
- no one provided significant appraisal assistance to the appraiser signing the certification except as noted.

Last, Rule 10-4 requires that an oral appraisal report address the substantive matters specified in Standards Rule 10-2(a).

In summary, USPAP comprises five sections. The Definitions section defines the terms that are used in the standards and how they are to be applied. The preamble then sets forth the objective of USPAP, which is to promote and maintain a high level of public trust in appraisal practice by establishing ethical and performance obligations for appraisers, while the Ethics, Record Keeping, Competency, Scope of Work, and Jurisdictional Exception Rules provide structural guidelines for how an appraisal—whether of real estate, personal property, or a business—should be conducted. The standards and standards rules stipulate the requirements for an appraisal, appraisal review, or appraisal consulting service, and the manner in which each is to be reported. Of the 10 standards and standards rules, Standards 1–6 concern real estate; Standards 3, 6, 7, and 8 deal with personal property, and Standards 3, 9, and 10 apply to intangible assets and businesses. Knowledge of these standards can assist counsel in working with and supporting a valuation expert, while serving to mitigate the potential for a successful Daubert challenge.

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