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I. MANUSCRIPTS

C. Published Journal Articles

19. "Appraisal Reform and Commercial Real Estate Investment for Pension Funds", Salomon Brothers, Inc., January, 1987

Index

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Appraisal Reform and Commercial Real Estate Investment for Pension Funds

by
James A. Graaskamp

Summary and Conclusions

The integrity of the appraisal process has always been critical to social equity in terms of eminent domain, real estate taxation, legal disputes, and contract administration. However, the credibility of appraisal for income properties has been undermined over the past 25 years by an implicit conspiracy between financial institutions and the real estate development fraternity for appraisal *form*, rather than substance. Traditional appraisal formats might have upset a profitable deal at a time when Regulation Q guaranteed infinite spread, and lending officers were driven by fees, arbitrage and fear of inflation. Credit and interest risk smothered concern for property risk.

- The impact of faulty appraisal on fiduciary institutions has been examined in a recent congressional study that blames the attitudes and policies of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Federal Savings and Loan Deposit Insurance Corporation (FSLIC), and other regulators. The study proposes legislation (HR 4956) that would place direct Federal sanctions on appraisers, investment officers and others, as well as tight procurement controls intended to protect appraisal independence.
- The FSLIC was recognized for efforts to define appraisal procurement through Memorandum R 41 (b) and the newly defined R 41 (c). These standards are enforced by an engagement letter with the appraiser and the placement of fiduciary liability for obtaining the required appraisal on the lending officer. This precedent will shape legislation and dramatically modify the power of the appraiser to protect his professional independence.
- Pension fund real estate investors need reliable real estate values to bring unit values of commingled funds and owned real estate to market value at least quarterly, to measure asset performance in terms of cash income and realizable appreciation, and to evaluate the relative performance of the asset manager. This creates an urgency for greater quality control in the procurement of appraisal services. Those responsible for guarantees under the Employee Retirement Insurance Society Act (ERISA) might find it useful to be included in HR 4956.
- The appraisal process is a key part of the larger business of providing objective financial information, and, like the accounting profession, needs to enhance the appearance (and the reality) of its own independence in the execution of the appraisal function, either through outside appraisers or inside fund management committees.

Intensive research of appraisal procurement procedures for pension real estate investments has identified joint but divided responsibility for improved appraisal practice.[1] Pension fund trustees must have an explicit statement of appraisal policy that will produce timely market prices, standard price communications formats, and preservation of appraisal independence. Pension sponsor rules on in-house quarterly appraisals must be contained in its contract with the asset manager, while its goals for the outside appraisal must be spelled out in a letter of engagement between the asset manager and independent appraiser — and reflected in more realistic compensation. However, the independent appraiser must protect his independence through his professional society, which will determine the protocols of independent information processing. Thus, appraisal

[1] *Implementation of Minimum Appraisal Standards for Valuation of Pension Fund Real Estate Unit Values*, Professors Robert Gibson and James A. Graaskamp, Research Committee of the Pension Real Estate Association, unpublished, October 1986. The report is available from PREA.

reform depends on greater sophistication and effort by the pension trustee, the asset manager, the appraiser, and the professional appraisal societies, which are the arbiters of ethics and practice.

The board of directors or trustees of pension real estate assets should require certain standardized output from the appraisal report, including probable price of the property sold as encumbered for cash, premiums or discounts to price for assumable financing or other entitlements not in the real estate fee, and probable value of leasehold interests.

- Appraisers should also take total probable price and, in some basic way, allocate total price among present value of cash flow under contract, additional cash flow assumed to be contracted for, present value of debt reduction during ownership, present value of reversion of original equity and additional equity investments recovered from resale, and present value in any growth in equity assumed to be realized upon resale. Unbundling the sources of return will pinpoint the forecasting risks in total value and also provide a benchmark for measuring asset enhancement over time.[2]

- The appraiser should test his probable price conclusion for reasonableness with a pattern of financial ratios, yields, and tests of investment returns to the next buyer based on assumed resale price.

- To avoid the risk of sophistry, the appraisal profession has defined market value as cash to the seller for real estate interests. The appraiser must report separately value premiums or discounts for financing, entitlements, or other business benefits included in the sale.

- Probable value of leaseholds is the best indicator of the upside potential value that can be recovered by aggressive property management, compared with value increases that depend on general market conditions beyond the control of the asset manager.

The appraiser should be the economic interpreter of the relevant facts about the property and its economic context. However, the impact of accounting procedures, engineering obsolescences, potential liability for environmental impact and toxic material, and anticipated revenues and outlays are part of an information explosion and exchange that modify the traditional independence of the appraiser and his use of declarations of nonresponsibility.

- Explicit professional protocols are needed to define when the appraiser can accept at face value data processing media on future leases and operating expenses, engineering reports, or property management programs. Replication and auditing by the appraiser might be expected, but cost-effective reports will lead the appraiser to rethink his relationships with other designated professionals and to take advantage of their expertise.

- Must the appraiser concur, validate, or simply assume that other designated professionals are providing independent information? Restrictions on the use of limiting conditions and assumptions should also be spelled out, lest appraisers abuse the credibility by indiscriminate hold-harmless declarations.

- Should the pension sponsor or asset manager provide express permission to use or to omit certain data sources without independent due diligence by the appraiser? The protocols of information sources and completeness require a policy statement by professional appraisal societies.

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2 "Component Capitalization," Gene Dilmore, *Real Estate Issues*, Volume 10, Number 1, American Society of Real Estate Counselors, Chicago, Spring/Summer 1985. For ease in accounting, certain components can be simplified to serve as a proxy; for example, cash flow under contract could be the first year's cash flow to avoid accounting allocation of current and future expenses.

The general objectives of value, benchmarks for measurement of performance, and communication of critical risk factors in the appraisal forecast assumptions desired by the investment trustees should be implemented by means of a standard letter of engagement between the asset manager and his independent appraiser; by contract between the trustees and the asset manager; and by an occasional spot-check of appraisals on file with asset managers by independent valuation consultants hired by the investment trustees.

Clearly, a better product from both in-house appraisal committees and independent appraisers will cost more money — at least three times as much as is currently spent.

- However, most of the unsystematic risk in real estate investment stems from the poor quality of information with which decisions are made, or the skepticism with which investors discount performance records based heavily on the appraisal process.
- Sincere efforts to establish the appearance (and reality) of reliable appraisal estimates of probable price must presume that the additional expense will be offset by lower risk premiums within expected investment yields, as well as by increased investment in real estate and in asset managers' fee income.

Responsibility of Pension Fund Sponsors and Asset Managers

A survey of pension fund sponsors and asset managers found that trustees and directors provided detailed policy statements on the procurement of insurance or the selection of asset managers, but had little to say in terms of written policy controlling the procurement of appraisals or, in the case of asset managers, the reporting of appraised values. For open funds, an independent appraisal is generally required once a year, but quarterly adjustments of value are provided by the in-house committee. Most committees could roll values forward on their own judgment, so there is little "independence" left in reported values other than the threat of a rollback of an in-house value by the next independent appraisal. However, most in-house committees were not required to abide by the independent appraisal. Asset managers would argue that appraisals tended to be more volatile than the market, and were often so far from the mark that they injected an element of unfairness in setting unit prices.[3] On the other hand, smoothing of erratic appraisal results may tend to suggest that the real estate market is less volatile than the stock market, leading to over-investment in real estate as a way of stabilizing portfolio values.[4]

One apparent reason for the cautious acceptance of independent appraisers seems to be the budget or average price per appraisal of a major income property. The average price (including both original and updated appraisal) was $3,000-$4,000, when well-trained commercial appraisers should bill out at $750-$1,000 per day. Even allowing for efficiencies of scale for an appraiser frequently operating in the same market, a $25-million building or shopping center cannot be fully inspected, comprehended, researched, and written up in three or four days without the risk of a significant oversight and misvaluation. An appraiser under these time constraints must take information provided by others at face value, and not exercise the due diligence required of an independent observer. In addition, such a budget does not allow any time to present value conclusions in several formats, which convert the data into appropriate measurements, information about the asset opportunity, comparative performance, or risk implicit in the appraiser's assumptions.

[3] See *Toward an Assessment of the Reliability of Commercial Appraisal*, Rebel Cole, David Guilkey, and Mike Miles, Appraisal Journal, vol. LIV#3, July 1986.

[4] See *The Relative Risk of Equity Real Estate and Common Stock: A New View*, David Shulman, Salomon Brothers Inc, June 30, 1986.

The small number of funds eager to maintain the dominance of the independent appraisal were also concerned about maintaining the economic independence of the outside appraiser and occasionally controlling systematic bias as a check and balance on innocent or malicious bias in the appraisal process. These funds limited the number of annual reviews of a specific property by a given appraisal company, as well as the dollar volume of business done with a specific appraisal company. Appraisal has much to learn from the accounting profession in terms of protecting its members against unacceptable pressures from clients. At the same time, the appraiser and the accountant must work together to define the accounting rules for measuring income defined on an accrual accounting basis.

These concerns have led to a proposed statement of appraisal procurement policies, which can be used by pension sponsors and their real estate asset managers (see Appendix 1).

Protocols Controlling Data Sources and Proper Appraisal Assumptions

Need for Data Protocols

The explosion of data, the recognition of the investment risk inherent in the quality of data provided, and the discipline and cost of electronic data processing have outstripped the working ethics and rules provided by professional appraisal societies. Many appraisers use outside market and engineering studies as a starting point for their work, using limiting conditions to provide a hold-harmless assumption on the reliability of the outside data. At the same time, the professional societies argue that use of an outside data source requires concurrence by the appraiser, implying that the appraiser has exercised due diligence regarding its quality. Some recent prospectuses have contained appraisal value conclusions wherein leases were read by one professional group of investment bankers who forecast revenue, while an accounting firm studied expenses and forecast outlay with or without engineering assistance — requiring the appraiser to place a value on a net income figure estimated by others.

These practices conflict with the concept of an independent valuation, at a time when the professional appraisal societies and accounting groups want to strengthen the appearance of independence. However, the cost of assembling detailed financial information suggests the practicality of allowing the appraiser to accept abstracts of leases, legal descriptions, accounting data, and engineering data prepared by others. Extensive hold-harmless clauses undermine the usefulness of an estimated sales price that does not consider legal, engineering, or environmental pitfalls. The appraiser has become the economic interpreter who must synthesize the significance of information from multiple professional sources into an estimate of the price at which a property would likely sell if buyer and seller were *fully* informed about all available facts. Such data must be available to the appraiser and assumed acceptable if received from a professionally designated accountant (C.P.A.), certified property manager (C.P.M.), professional engineer (P.E.), attorney (J.D.), or registered architect (A.I.A.).

Alternatively, the client or investment banker could provide necessary data with a guarantee of reliability and financial guarantee of damages for misrepresentation. Indeed, in the future, appraisers may have these other professionals in their office as part of a natural clinic of professional real estate services. The professional societies must issue a statement on data protocols, and major data incompatibility issues must be addressed regarding the appraisal and accounting interface, legal concepts of real property, pitfalls inherent in land use control, legal liability for environmental degradation, and the risk of future subtle distortions based on the future by extrapolation of the past.

Major Data Gaps for Appraisal/Accounting Protocols

The valuation of income real estate properties now relies more on discounted cash flow simulation of property performance or a single price/earnings ratio method called direct capitalization with a single overall rate. Discounted cash flow presumes the real estate is simulated on a strict cash accounting basis, while the Financial Accounting Standards Board (FASB) advocates accrual accounting for real estate including adjustment of nominal debt to economic equivalents. This will become extremely confusing for both appraiser and those who will rely on appraisal reports. The asset management association can have an impact in this regard by setting a standard to which all members must subscribe. Ironically, the direct capitalization rate method is often based on an economic accrual method with reserves for replacement of short-lived items — a method of smoothing net income that would be unfathomable to FASB and its goals of measuring economic productivity. Our review of many appraisals revealed unwarranted manipulation of direct capitalization. Rates derived from market transactions relied on engineered prices and estimated incomes, while those that came from a loading of points to some base rate — such as a tax-exempt bond or middle-rated industrial bonds — were never supported by evidence from interviews with institutional buyers. The method of building a capitalization rate conceals implicit assumptions about a trendline of future property income.

The major accounting/appraisal conflicts regard the amortization of deferred expenditures or tenant improvements, leasing commissions, points paid for long-term financing, and deferred maintenance combined with capital improvements.

Another major area of concern is the need to allocate or attribute income to land, building, tangible personal property, intangible personal property, and working capital. When should the appraiser delineate revenues from the real estate enterprise, and when should he value the whole as a going concern? This also provides the asset management association the opportunity to set standards for the accountants (see Appendix 1, Section G and H).

Major Issues for Appraisal/Engineering Protocols

Traditionally, the appraiser side-stepped encroachment on the other professions by denying responsibility for legal or engineering issues, unless physical structural failures were clearly apparent. However, appraisal evaluations that ignore basic obsolescence in terms of energy consumption, maintenance cost, or environmental risks for such things as asbestos and toxic waste can be construed as misleading, and a major concern of appraisal reform is to avoid the sin of omission — which is implicitly misleading. Therefore, the logical sequence of appraisal would be to incorporate engineering surveys of the structure, its equipment, and its site done before the appraisal.

The Appraiser and Building Management

The appraiser relying on discounted cash flow is forecasting future productivity, but many dollars depend on execution of the property's management plan, which will alter size, tenant mix and operating characteristics. Should the appraiser accept the management plan of current ownership in forecasting, or review several alternative scenarios for the future of the property? One view would be that pension sponsors have a right to know that an independent appraiser has reviewed the asset manager's plans. The other view is to assume the professional property manager will enhance the asset, and subsequent updates of the appraisal will recognize failure. A third perspective would be to value the property exactly as it exists on the day of valuation, extrapolated into the future as though the property were not to be enhanced. To avoid a systematic upward bias of value that hinges on the successful completion of grand plans, we believe that the latter method should be used.

The appraiser's expertise is the collection and analysis of market data and off-site transactions, while the accountant and designated property manager are responsible for on-site data collection and control. Traditional appraisers were expected to reconstruct lease roles, profit and loss statements, property management strategy, and a buyer's probable financial structure, rather than simply accept data from others. Given the costs of microdata review, should the appraiser be expected to audit data generated internally? The appraisal societies and asset managers must define the following:

1. Responsibility of the appraiser to flag legal, engineering, traffic, or structural issues requiring professional review;

2. Legitimacy of the appraiser's accepting audits of leases, operating budgets, and revenue collections provided by other professionals;

3. Legitimacy of the appraiser's accepting data on such electronic media as floppy disks for use in cash flow or data management models provided by the asset manager client, the accountant for the client, independent purveyors of software and operating data, and investment broker/ marketing.

4. Legitimacy of the appraiser's accepting a property management program implemented by the asset manager as a point of departure for future revenues, expenses, and project characteristics of extrapolating the status quo.

The complexity of the appraisal question in terms of income properties is illustrated in Figure 2. In the past, the appraiser was superficially conversant in property management, finance, marketing, and basic engineering — and this general level of expertise presumably protected his independence. Now, a pool of intensely technical data from numerous sources is used, and the appraiser must rethink the protocols of using other sources of data for efficiency and reality while maintaining neutrality and independence.

Institutional Forces Accelerating Appraisal Relevance and Reliability

The appraisal process was not prepared to provide a large volume of valuation services with tight quality control once pension institutions recognized the validity and necessity of real estate equity investment, as such a commitment had to be supported by a constant feedback of performance, safety, yield, and liquidating value information.

Concurrently, traditional intermediaries of mortgage debt euphorically shifted surplus capacity toward construction financing of the real estate product, presumably to exploit the new equity markets. Coincidentally, foreign investors were also willing to expand their participation in U.S. real estate capital markets. These major players, their regulators, and their beneficiaries perceived the need for reducing the information risks in real estate investments and for adapting real estate data formats to be compatible with other portfolio financial reporting standards.

The ultimate control of the appraisal product will be a letter of engagement, with certain requirements sanctioned by such trade groups with a common interest as pensions, investors in Federally insured projects, or group equity pools. This letter will be subdivided into four sections: specifications of the assignments, appraisal protocols, appraisal methodology, and appraisal business arrangements.

Each section will incorporate the current standards and practices for appraisal and accounting relative to investment properties that have been promulgated by the following groups.

Federal Regulators for Financial Institutions

Congress has been investigating the impact of inadequate appraisals for commercial real estate lending, as well as failures of residential lending appraisal and its adverse impact on mortgage insurance and secondary market investors (see Appendix 1).

Congressional investigators lament the relatively limited opportunities that professional societies have for policing appraisal quality, but are harsh critics of the Federal agencies regulating the fiduciaries that failed to act when audit procedures revealed widespread weakness and fraud in the appraisal control of the investment process.

Congress points out that the FDIC, the OCC, or the National Credit Association (NCA) do not require appraisals for all real estate loans, and suggest that these agencies' attitude toward appraisal is naive at best and irresponsible at worst. Its report suggests that commercial real estate borrowers are shifting their loan applications to banks and insurance companies and away from thrifts because Memorandum R 41(b) is being enforced.

Congress can be expected to force corporate fiduciaries to modify and improve appraisal procedures greatly or to face personal liability for dereliction of duty, as is true under R 41(b).[5]

The Federal Savings and Loan Deposit Insurance Corporation has issued the most comprehensive appraisal procurement standards in the United States. This is currently referred to as Memorandum R 41(b), but will soon be corrected for certain ambiguities as R 41(c). This document is appropriate for income properties under development, and it also imposes a breach of fiduciary trust on the asset manager who does *not* insist on receiving an appraisal according to R 41(b) standards.

The Federal National Mortgage Association and Federal Home Loan Bank Mortgage Corporation have redefined market value, best use, and the relevance of sales to control the underwriting of apartment projects and condominiums. These controls emphasize cash equivalency of investment value.

Professional Appraisal Societies

The American Institute of Real Estate Appraisers and the International Society of Real Estate Appraisers have reaffirmed their codes of professional conduct and removed possible ambiguities from their terminologies.

Market value has been clearly defined as the most probable price at which a property would sell for cash to the seller, assuming knowledgeable buyers and sellers under no special duress and including time on the market. This benchmark value must then be adjusted for financing, other entitlements, or encumbrances that would modify the cash value (see Appendix 2).

The appraiser is expected to exercise due diligence in the selection and utilization of all relative data, and concur in the data used. The basic standard is that the appraiser must report all data and procedures used so that his work can be replicated and validated to avoid miscommunication, disinformation or sophistry.

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[5] For recommendations and provisions of HR 4956, see Section IV in "Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market," Housing Report 99-891, by the Committee on Government Operations, September 25, 1986, based on a study made by the Commerce, Consumer and Monetary Affairs Subcommittee.

As the groups receive legislative help in protecting the appraiser against economic intimidation from the client, they will take advantage of the wave of reform to establish significant controls on their membership and methods.

Credibility will mean higher fees, longer apprenticeships, and more reliance on college training — specifically in land economics and land valuation. These professional characteristics are already found in Europe and in the British tradition of value surveyors.

The FASB has published a report about the appropriate use of cash or accrual accounting that will conflict with traditional appraisal and pension fund practices.

Several of the Big Eight accounting firms have set up special appraisal review departments, since accounting practice no longer permits the auditor to sign off on appraised asset values without judging the adequacy of the appraisals.

The European Common Markets Accounting Fraternity, aided and abetted by the Royal Institute of Charted Surveyors, has implemented a 250-page set of standards for the appraisal of fixed assets (including real estate) for various financial reporting services; a special section is devoted to pension fund real estate. These standards are incorporated by reference into appraisal letters of engagement. There is continuing review and improvement by the International Assets Valuation Standards Committee.[6]

Other Institutional Changes

The quickest way to introduce better appraising methods is for a particular user group to define appropriate methods and inappropriate logic in the procurement of appraisal through a standard letter of engagement. Both the Pension Real Estate Association (PREA) and the National Council of Real Estate Investment Fiduciaries (NCREIF) are about to endorse such a letter for their members. These define property interests and definitions, appraisal methods, reporting requirements, and the business relationship between appraiser and asset manager, including the following:

(1) Full disclosure of comparable-market sales data.

(2) Reliance on discounted pretax cash flows, with emphasis on consistency of financial ratios.

(3) Full disclosure must incorporate engineering and other professional studies, rather than ignore them by means of hold-harmless clauses.

The universities have developed several appraisal systems that can drive off computer data banks to automate market comparison valuations of industrial land, farm land, wilderness, and swamp land, as well as match attributes of major commercial properties.

Conclusion

Recognition of the pivotal social and financial responsibilities of appraisal by sophisticated investors and public regulators will cause the appraisal profession to leap into the 20th century of financial information. The carrot will be the opportunity to be paid well for providing the best valuation material technically possible because of the value-added from reduced information risk. The leap will be assisted by sharp prods from the Securities and Exchange Commission (SEC), bank regulators and appraisal professional societies who will otherwise be replaced by the accountants.

[6] For additional information, write the Secretary, TIAVSC, 103 Mount St., London, W17 6AS, United Kingdom.

* * *

Appendix 1. Pension Fund Managers' Appraisal Policy Statement to Inform Investors of Real Estate Appraisal Policy

A. Definition of real estate investment categories and appraisal value relevant to the following:

Investment-grade properties (operational and 80% occupied)

1) Market value of leased fee;

2) Leasehold value to be recaptured by property management; and

3) Financial or contract agreements to be transferred with sale that add or detract from market value of leased fee (such as discount for high-interest mortgage without right of prepayment, or additional value of transferable development rights or surplus land).

Development Properties[a] (Vacant, Transition, or Less Than 80% Leased and Occupied)

1) Cost outlays or market value, whichever is lower in value; and

2) Future value discounted by cost to complete, and value created by development process, as in R 41(b) prototype.

Financial Participation Contracts[b]

Investment value as discounted cash flow less reserve for resale cost (custom-crafted, hybrid equity contract unlikely to meet presumptions of fair market value).

B. Specific questions to be addressed by independent appraisal value determination:

Market value of a specific interest in a specific property, given income and resale prospects for the underlying collateral as of a specific date.

Appraiser shall provide selected tests of appraisal conclusion that may indicate reliability, including illustrative tests that will vary according to the nature of the property and critical assumptions and are intended to reveal error or suggest reliability:

1) Indicated compound growth rates for effective gross rent, operating expenses, and net operating income, compared to assumed market rental growth rates or expected rates of inflation.

2) Financial risk ratios such as debt-coverage ratio, cash break-even ratio, or range of tenant turnover cost to projected revenue, compared to average vacancy loss in the local market.

3) Ratio of projected potential rent rate to current market rental rate projected at standard growth rate.

4) Sensitivity analysis should be applied to critical assumptions.

5) Whatever formula is used to hypothesize resale price at the end of the investment, the appraisal should compare the resulting resale cap rate with the inferred "going in" cap rate, computed by defining net operating income for year one by appraised value conclusion.

Where appropriate, the appraiser should unbundle the value conclusion as to the proportion of total value contributed by certain categories in order to facilitate understanding of the relative significance of existing contracts, operating assumptions, and future contingencies.

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[a] Not subject of current study; recommend R 41(b) model.
[b] Valuation process subject to PREA research under the direction of Professor William Brueggeman of Southern Methodist University.

C. Definition of frequency of appraisal by independent appraisers:

Annual appraisals for open-ended fund.

Three-year appraisals for closed fund.

Whenever value changed by in-house managers exceeds 5% of previous independent appraisal or 1% of total portfolio value.

Change of more than 10% in capital investment through partial sale or expansion and refurbishment.

Independent appraisals scheduled to reappraise approximately 25% of portfolio value each quarter.

D. Protection of appraiser independence and control of accidental or systematic bias in the independent appraisal process:

Requirement that appraiser be controlled by a specific professional code of ethics and standards of practice and definition of terms, regardless of whether he's a member of that professional organization.

A specific individual with experience in property type must sign the appraisal and be accountable for it (compared with the accounting practice, for example, where a firm name can be used).

Sponsor should provide guidelines limiting the percentage of portfolio value assignments to be given to the same appraisal firm and percentage of appraisal firm gross income comprising fees generated by one asset management firm. Fees to be due and payable upon receipt of report, rather than upon review or acceptance.

Appraiser should be guaranteed at least one update before reassignment to reduce intimidation.

Appraisal assignment should be reassigned to an alternative appraisal firm after a specified number of updates, such as three consecutive annual valuations.

E. Supply appraisers with engineering report, investigation allowance or waiver of responsibility, for the influence of the following:

Engineering reports on structural matters, expansion capacity or programmed improvement budgets.

Analysis of HVAC system in terms of BTU and kilowatt-hour deficiencies, or the cost to cure known trouble spots.

Toxic wastes in the ground or spilled on the site.

Asbestos removal or other building code internal hazards.

Survey, deed restraints or development code restrictions whose impact could hurt building value in the marketplace.

Existing studies of programmed renovation budgets or cost-to-cure studies of parking, life safety, vertical circulation, or other systems critical to long-term value trend.

F. Pension sponsor should set guidelines that permit the appraiser to accept the abstracts of leases, engineering studies, electronic accounting data, and other information from others subject to some guarantee about the authenticity of the data and the appraiser's degree of accountability for spotting errors or due diligence review of the data. Pension sponsor may ask the appraiser to indicate the alternative cost of using proffered material or independent study by the appraiser and his subcontractors.

G. Definition of in-house appraisal procedures to protect reliance of investor on independent value estimates:

All valuations are ultimately the responsibility of an in-house valuation, since the in-house procedure will set the value during at least three quarters each year and may override the conclusions of the independent appraiser. The independent appraiser is essentially auditing the objectivity of the in-house group, by referring to external market facts, local conditions, and freedom from collective optimism of the ownership. The in-house committee must avoid the subjectivity of a single individual, must establish a consistent procedure, and must record critical factors in their valuation process to be addressed explicitly in the next independent appraisal. Fund management must limit the deviation of annual independent values from in-house values to not more than 5% from the lower value, before calling for an independent update.

The in-house review committee will consist of no less than three persons, one of whom must have appraisal background; the third may be the property manager responsible for the asset. Acquisition agents, general management personnel or institutional officers involved in fund marketing cannot be official members of the in-house review committee.

In-house appraisals of individual properties shall be provided as necessary to set portfolio values for official purposes, and a summary of appraisal considerations must be put in writing in the property file each time the appraisal is reviewed or adjusted, indicating the reasons for the action taken. Key assumptions of the in-house committee must be analyzed explicitly by an outside independent appraiser at the time of the next independent appraisal.

Period values should be reported in a format to indicate value reported by the last independent outside appraisal, value added by additional capital investment from that date, value lost from partial sale, equity withdrawal, or other financial adjustments, and value lost or gained due to in-house adjustments and the net value at the close of the subject period. Finally, the report should indicate the total change in value since the previous period of valuation.

Fund managers must define accounting rules for operating income distinct from capital investment outlays for amortized leasing commissions, tenant improvements, lease repurchase, and for renovations. Added investment between independent appraisals will be superceded by the next independent appraisal with an appropriate adjustment to additional capital investment.

H. Optional policies of pension fund sponsor or fund management:

Explicit rules for spot-checking appraisals on a random-audit basis by contracting with a real estate counseling, appraisal, or qualified pension fund consulting firm for an appraisal review (not unlike similar review of property-specific insurance).

Specific rules for property inspections by an independent engineer/ architect observer to spot-check properties owned and managed by a commingled fund in which the pension sponsor has invested.

Specification of accounting format for real estate assets by class of asset or enterprise unit, with possible asset allocation among land, building, tangible personal property, or intangible going-concern values.

Special studies where fund sponsors or asset managers perceive a risk concentration by property type within a specific market area. (It may be desirable to contract for specific research on supply and demand trends related to economic base and demographics, fiscal trends in the community that will affect the real estate tax and resulting cost of occupancy, and other land use trends or plans that may have a foreseeable effect on investment concentration or changing institutional ownership patterns in the market.)

Appendix 2. Appraisal Protocols Regarding Data Sources and Assumptions

Appraisal protocols are concerned with responsibility for supplying data and critical appraisal assumptions and the degree to which the appraiser must concur, be held harmless, or empirically validate through independent research the data in question. The issues raised by protocol grow out of the availability of electronic data files, the increasing conflicts in accounting and valuation procedures, the growing legal and engineering pitfalls of land use control, liability for environmental degradation, and a trend toward computerized modeling of future property market and financial performance.

	Appraiser Supplies	Appraiser Reviews	Appraisal Society Standards	Appraiser's Engineer	Owner's Legal Services	Owner's Policy Statement	Property Manager	Owner's C.P.A.	Owner's Architect	Asset Management Standards
Legal Description of Property Interest					x					
Deed Restrictions and Covenants					x					
Five-Year Chronology of Ownership and Transactions Involving Transfer of Fee		x			x					
Lease Abstracts		x					x			
Engineering Assumptions				x		x			x	
Strategic Management Plan		x					x		x	
Definition of Values to be Reported			x			x				
Application of Market Comparison Method and Unit of Comparison	x		x							
Application of Cost to Replace Method and Accepted Cost Service	x			x		x	x		x	
Application of Normalized Income Capitalization	x		x							
• Adjustment of Accounting History to Establish Normalized Statement	x						x	x		
• Treatment of Existing Financing	x		x		x	x				
• Logic for Income Capitalization Rate								x		x
Cash Flow Format		x								x
Cash Flow Forecast	x									x
• Revenue Under Contract							x			
• New Contract Revenue		x					x			x
• Lease Turnover Costs		x					x	x		x
• Rental Concessions		x					x			
• Market Conditions, Leasing Strategy, and Net Capture	x									
• Gross and Net Operating Expenses		x					x	x		
• Gross and Net Real Estate Taxes	x	x						x		
• Third-Party Financing Format for Most Probable Buyer	x									
• Present Value Disaggregated by Source of Financial Interest	x									x
Economic Environment	x		x							

Note: X equals source and/or responsibility.

* * * * *