JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

VI. ACADEMIC ASSOCIATIONS

D. Lincoln Institute

1. "Institutional Constraints on Redefinition and Reform of the Appraisal Process", Paper given at the Lincoln Institute's Appraisal Colloquium in Storrs, Connecticut, June, 1984. Also Contains Graaskamp's Introductory Comments, "The Need for Redefinition and Reform of the Appraisal Process"

Index

Revised

INSTITUTIONAL CONSTRAINTS ON AND FORCES FOR EVALUATION OF APPRAISAL PRECEPTS AND PRACTICES

Note slight change in wording of title on following page

INSTITUTIONAL CONSTRAINTS
(Institutional-Push)

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INSTITUTIONAL CONSTRAINTS ON REDEFINITION AND REFORM OF THE APPRAISAL PROCESS

Professor James A. Graaskamp

INTRODUCTION

The appraisal process is pivotal in our society relative to decisions involving social equities, efficient capital allocation, land use, and management of real estate wealth. Issues or questions for which appraisal serves as an important benchmark are becoming continually more complex. Often those requiring valuation mistakenly presume a universal relevancy in the appraisal process to meet their specific needs. A suggestion of the multiple roles where appraisal value shifts in definition and scope as a part of an institutional ethic is provided by Exhibit 1. Institutional ethics may, however, be undermined by the institutional economics governing appraisal innovation. A grass-roots response, sometimes characterized as a guerilla movement by leading appraisal professionals, adapts and applies the best of current pricing theory and information processing technology to appraisal problems. Although these efforts are consistent with the assertion that America is a grass-roots society (1), it is odd that there has been no effort to incorporate grass-roots redefinition, restructuring, and standardized guidelines that can be promulgated from the top down within the specialized area of information management called professional appraisal. Professional appraisal societies have yet to produce a single white paper in response to current

EXHIBIT 1

PURPOSE	ECONOMIC INTERESTS TO BE VALUED	DEFINITION OF VALUE
A. Social Equity		
1. Real Estate Taxes	Economic surplus attributable to land and buildings.	Highest Cash Market Value before Income Tax.
2. Legal Compensation	Compensable real estate elements taken.	Cash Market Value reasonable for both seller and buyer.
B. Validation		
1. Regulation of Lending	Exit value of asset in liquidation.	Cash Market Price under duress
2. Auditing of Assets	Historical value of asset acquisition.	Confirmation of book value or equated value.
3. Income Taxation	Financial surplus allocated to reflect economic substance.	Capital asset pricing limited by market behavior and tax code definitions.
4. Insurance	Insurable interest in burnable components of real estate.	Cost to replace or defined cash value
C. Benchmarking Performance		
1. Pension Fund Adequacy	Exit value of asset in liquidation. (Involuntary conversion value)	Market price under duress
2. Comparative Management Adequacy	Entry value of asset in normal course of business cycle for next investor.	Most probable sales price at terms characterisitc of market for combined real estate and personalty.
3. Management Compensation	Marginal value added attributable to management after deductions for cost of capital from economic surplus.	Most probable cash sales price
D. Counseling Changes in Real Estate Commitments		
1. Setting Market Prices	Future economic surplus, income and positioning to control tax shelter appreciation, and related profit centers.	Most probable price and terms
2. Forecasting Purchase Prices	Market perception of future surplus and positioning for control of other profit centers.	Most probable price and terms
3. Life-Cycle Costing of Alternatives	Present value of net outlays for public buildings. Present value of all future outlays.	Cost to create and operate
4. Constructing Risk/Payoff Matrices Under Uncertainty	Present value sensitivity arrays of combined land, building, and management contributions.	

appraisal issues, let alone a response parallel to the accountants' Financial Accounting Standards Board (FASB) 33 belated response (2) to government's meddling in accounting via Securities Exchange Commission's (SEC) ASR 190 (3). The appraisal principles textbook (4), much quoted as an authority in the courtroom and other argumentative prose, carries a disclaimer that the Institute has any intent to suggest a standard. The laissez faire of appraisal organizations relative to matters of theory and methodology is in sharp contrast to the voluminous pronouncements of accounting standards by FASB, particularly so when the appraisal of income property and pools of real estate investment are accelerating a merger of interests between accounting and appraisal in some aspects of income forecasting and operations monitoring.

The observable lack of effort by professional appraisal groups to provide a continuous and vigorous review of methods and concepts to control a dynamic appraisal process responding to current issues and competitive encroachments of other professions must have an explanation. Their leadership is dedicated, and intense, but energy is squandered on organizational matters, and issues of substance are delegated to inbred, part-time committees of elders. The brilliance of individual appraisers is seldom reflected in the professional standards of the group. The general argument of this essay is that the static public posture of appraisal theory is a classic demonstration of institutional economics at work (5). Despite the general recognition that the appraisal business will be swept along as a part of the revolution of information systems and decision modeling disciplines, this essay will argue that reform and redefinition is frustrated because they both are counter-productive in the short run for established appraisal institutions, and adverse to the short-term institutional economic interests of their major customer groups. Of course, in the long run, the failure to act as professionals by addressing change will be fatal to both appraisal and financial institutions.

The structural weakness of appraisal organizations in the United States has permitted the consumer of appraisal services to co-opt the process of defining appraisal procedure as a de facto conspiracy to dilute regulatory constraints on business activity. Since the 1900s the rise and fall of real estate finance institutions have always been aided and abetted by the corrosion of the appraisal process caused by their customers in banking and finance. The only meaningful reforms of the appraisal process have depended on the fact that cost/benefit ratios to the public welfare favor government agencies pressing hard for upgrading of appraisal techniques and concepts (6). At the least, implementation of contemporary appraisal procedures will be initiated by federal agencies concerned with social equity and institutional solvency of banking and pension institutions. At best, such strong interference in the domain of professional appraisal societies will enervate these groups to a professional response and review. At worst, major regulatory groups will usurp the professional function of redefinition.

I. APPRAISAL PROCESS AS A DECISION MODEL

Appraisal methodology is a model for information processing with which to edit and structure information to focus on topical questions involving the elusive and evolving concept of real estate value. Value is a dynamic element, sometimes reflecting the value of the utility contribution of real estate to the establishment housed, sometimes the financial value of claims on the asset, sometimes the going concern value of real estate as a captive customer for services, and other times its commodity value as a long-term speculation in fungible space-time units. Continual redefinition and reform of appraisal methodology is a requirement for the dynamics of any information processing model when the technology of information, techniques of systematic interpretation, and complexity of issues are evolving quickly in matters related to land. Market value today as an objective need not be any more static in character than the substance of rights implied by the aging term, fee simple title.

The model for information processing for any topic of inquiry has certain opportunities within six basic constraints on any modeling effort, sketched as follows:

A. The question or issue for which the appraisal is required as a benchmark must be clearly and precisely stated. Reference to Exhibit 2 suggests how each change in question alters the property interests and the most appropriate valuation methodology. While accountants debate proper application of entry value, exit values, historical costs, replacement costs, or remaining productivity values, appraisers seem to believe that fair market value measures cash solvency values for the pension fund, most probable price with seller financing

EXHIBIT 2

Critical Issues That Define Appraisal Process

Function of the Appraisal	Property Rights	Relevant Definition of Value	Allocation of Productivity	Buyer Motivation Presumed
Tax assessment	Fee simple private rights unencumbered	Cash market present value (As opposed to most probable selling price)	Present value income attributable to land and structures only	Purchase of economic productivity
Mortgage loan (nonparticipating)	Encumbered fee simple private rights plus additional rights pledged	Regulations - market value Underwriting - solvency price or liquidating value	Fixed income pledged from all sources less costs of creative management	Share of economic productivity contributed by capital
Mortgage loan (participatory)	Encumbered title plus nonvested interest in selected future revenues	Present value of all future cash flows	Variable income pledged plus share of reversionary interest	Share of economic productivity contributed by capital plus share in selected management returns plus positioning against devaluation due to changing conditions
Sale of an investment	Encumbered title plus vested entitlements plus going concern profit center opportunities	Most probable price above minimum acceptable alternative opportunity	Returns from land, structures, personalty, and selected entitlements	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Purchase of investments	Encumbered title plus positioning for access to entitlements	Most probable price within perceived peril point limit	Land, structure, personalty, and intangible assets less profit centers for management	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions
Going concern purchase of a business	Encumbered title plus positioning for access to entitlements plus reduction in risk for business start-up plus control of monopolistic market position controls	Most probable sales price within perceived costs of creating an alternative	Land, structure, personalty, and intangible assets and good will plus artifactual profit centers for management	Increase in spendable cash Increase in liquidity value of estate Positioning to maximize probability of survival of benefits despite changing conditions

and with proper timing, or justified purchase value with seller financing, or assumptions about non-vested interests in inflation, as the same value applicable to all questions.

B. Data with a plausible tie to the question must exist, and certainly there has been an explosion of information and data systems for retrieval that can be assimilated into the appraisal process with sorting concepts that go beyond intuitive, subjective manual procedures.

C. There must be a proven, reliable hypothesis to focus data into a decision format. The gross rent multiplier is such a hypothesis about the relationship of market price to gross rent when those are the only data points available for comparative purposes. But today, investors buy cash flow with complex twists and turns, or environmental diversity and unique physical resources, or business opportunities that involve a large piece of real estate.

D. The hypothesis about the data must be applicable in a way that is cost effective for both the client in terms of the dollar significance of the decision to be made and the consultant in terms of his time and overhead.

E. The model chosen must have credibility with the client who will make the decision, and who in most cases has simply required the appraisal for the peace of mind that comes with believing in the certainty of the value.

F. Compatibility of modeling techniques with the abilities of the appraiser are the final constraints. The Ellwood model not only lacked credibility with the lendors but was limited in part to those appraisers who could use decimals and long division, not to mention understanding the abstract implications of compound interest.

Because the profession is careless in working with clients to delineate the issue for which the appraisal is sought as a benchmark, the appraisal model has become stereotyped. Clients are more sophisticated than appraisers in many aspects of investment and engineering and are disappointed with traditional models. The explosion of data, progressive declines in the cost of data processing, advances in investment theory and decision theory all suggest the real constraint on appraisal models is the commitment of those who implement the models as appraisers and their professional organizations that advance the credibility of innovative models. However, even the traditional three standard approaches to value have their historical origins in a confusion of purposes, modeling assumptions, and emphasis on the normative.

II. HISTORICAL APPRAISAL MODELS

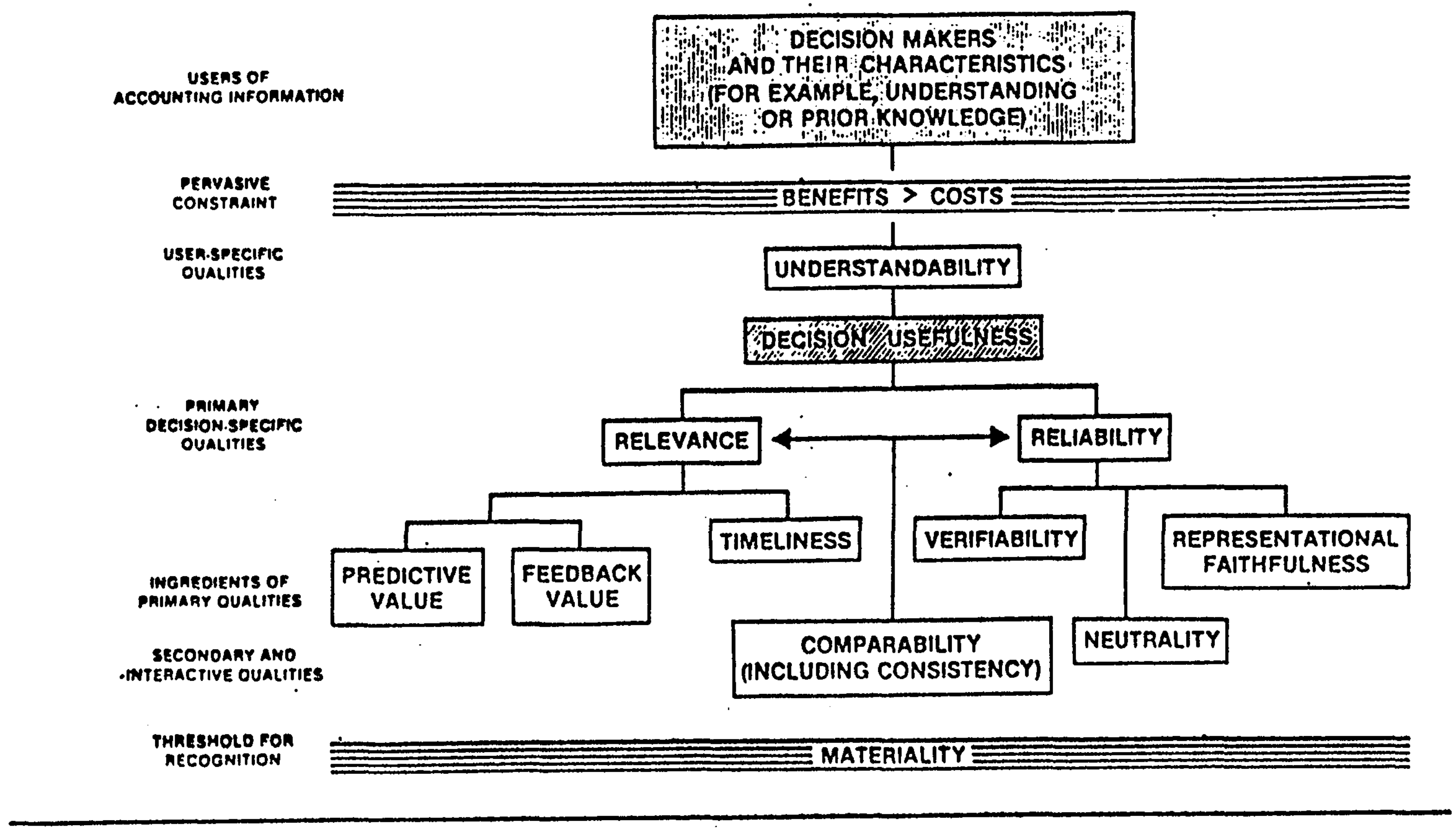
No hint of the need or desirability of synthesizing three approaches to value appears in appraisal literature (7) until the disarray of real estate markets and financial institutions in the 1930s required a new consensus on the substance and methodology of appraisal for the public good and for renewed trust in financial institutions. The synthesis of three approaches which dominates appraisal form is a pragmatic political accommodation to co-opt the three major powers needed to endorse national efforts to legitimatize the appraisal process and a national appraisal organization. Major consumers of appraisal services were insurance companies and banks who were biased toward the cost approach to feel assured that the borrower would have substantial amounts of their own money spent on development before institutional dollars were laid out. At the same time, the income approach was advocated by Richard Babcock, the academic, who was then forming the appraisal thinking of the Federal Housing Administration so that his text and theory had unusual leverage for an academic. The market comparison approach was advocated by the realtors who controlled NAREB, under whose umbrella an appraisal group was to be formed. The realtors not only controlled market data sources and had need of appraisal fees to sustain business income, but the realtors also represented the conventional wisdom that "the value of a thing was the price it would bring." A consensus to create a unified front of these major market forces on matters of appraisal could be neatly served in the time-honored American way of synthesizing the protagonists into a three-approaches model. The model could be conveniently legitimized by reference to Marshallian economics with its premise that short, intermediate, and long-term prices tended to converge toward cost to replace. The result was a single answer fair market value intended to serve most questions in a general way, just as GAP accounting was intended to provide a generalized format for balance sheets and income statements. The generalized format did not stress cash flow or current investment prices or futures--just standardization for purposes of comparison at a specific point in time. But accounting has continued to grow in terms of definitions and formats for specific purposes, while appraisal metaphysics has remained officially static.

III. COMPARISON WITH MODELS OF ACCOUNTING PROCESS

Although appraisal is concerned with future events and behavioral economics, and accounting is primarily tied to reporting of historical business transactions, accountants provide some useful analogs as to what should be expected of an economic value reporting model. A hierarchy of standards in accounting is provided in Exhibit 3. These guidelines address the very issues that militate for redefinition and reform of the appraisal process:

EXHIBIT 3

A HIERARCHY OF ACCOUNTING QUALITIES



SOURCE: Financial Accounting Standard Board, Qualitative Characteristics of Accounting Information, Statement of Financial Concepts No. 2 (Stamford, Conn.: Financial Accounting Standard Board, May 1980), p. 15, Figure 1.

1. Relevance of the accounting product (8) to the purposes for which the data was assembled requires flexibility from cash to accrual accounting, entry or exit value under normal or liquidation modes, and more or less precision in allocation among tangible and intangible assets. Appraisers have only recently made value explicitly sensitive to terms of sale, and cash to the seller (9).

2. Verifiability makes it possible for accountants to replicate their conclusions following general principles, while appraisers have grown into the practice of concealing their adjustments and data sources and insisting that the user trust the appraiser's black box.

3. Freedom from bias has to do with matching of revenues and expenses or mismatches of asset values and salvage values, for example. Appraisal bias is well illustrated by the difference between the British technique for rolling future leases at current market rates, while Americans roll future leases at an inflation-indexed market rate, which tends to bias values upward with nonvested interests in future inflation made explicit in the rent schedules, rather than operating implicitly through the discount factors.

4. Independence of the accountant is critical in the monitoring and auditing of financial activity.

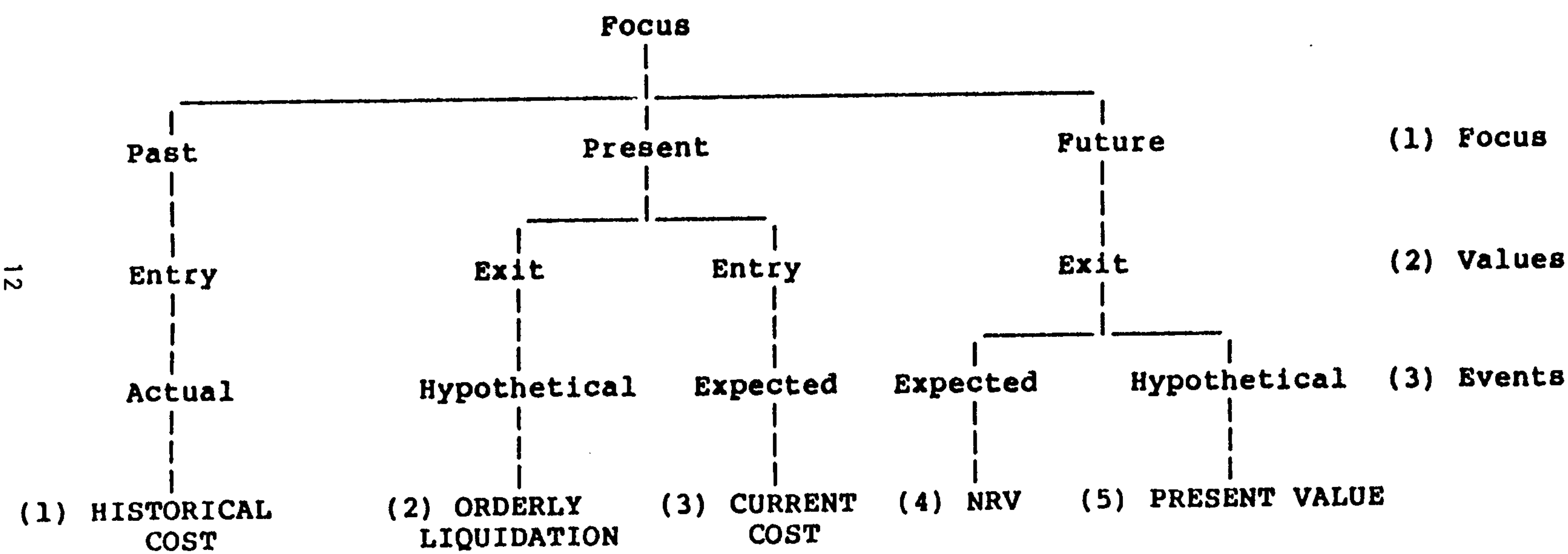
5. Quantifiability of assumptions means that each financial product has a mathematical algorithm with an explicit set of assumptions for which there is a recognized logic. Many appraisal reports appear to be poetically whimsical in terms of quantities assigned.

6. Accountants match the issue or focus of accounting rules to both the relevant definition of value and the nature of the event required to realize value, as illustrated in Exhibit 4. The adequacy of pension funding is a function of expected Net Realizable Exit Values, while investment performance may involve the present value of hypothetical expectations. Similarly insurance regulators and bank regulators should be interested in liquidating values of home offices or mortgage collateral properties. Since appraisers are permitted to fudge exit values for liquidation and fair market value assuming most favorable ongoing business scenarios, many corporate assets of financial institutions are overstated.

Certainly, the appraisal process needs to examine the role of the Financial Accounting Standards Board, the accounting protocols for fees and client relationships, and the tight

EXHIBIT 4

COMPARISON OF ATTRIBUTES



affiliation of those developing theoretical standards with universities. Indeed, in many business schools, accounting dominates the curriculum and resources. Structuring of accounting partnerships to incorporate a group of professionals with various specialties around a field force that is continually trained in data collection and assembly cannot be shrugged off by an appraisal industry that has romanced itself on the one-man, jack-of-all-trades professional who cannot afford to hire a college graduate assistant. Accounting firms are moving quickly into the related field of appraisal and are held in check by accounting standards of performance without conflict of interest. Conflicts of interest have no explicit checks where financial institutions do their appraisals inhouse, where investment bankers employ designated appraisers on salary for the creation of investment product, or where the appraiser contaminates his objectivity with the euphoria of his brokerage assignments. Accountants as a group are much more nervous than appraisers about cash flow forecasting techniques and representations. Appraisers as a group are not even uneasy about their homespun accounting analysis of income properties and their general account ledgers. In short, appraisal education lacks the detail of accountants' hopes for its membership standards and the acute sensibilities of the accounting organization about their need for independence. Accountants feel the pressure of liability to those who rely on accounting judgments, even where there is no privity of contract between the accountant and those who rely on his work. Few believe that the accounting process has met all of its standards and, indeed, unrecognized bias in accounting has led to many excesses such as manipulation of earnings through merger in the early 1970s. Prompted by the SEC, accountants modified merger accounting and introduced replacement value alternatives to correct for distortions of previous practices (10). But the potential bias in appraisal, manifested by current syndications, reported appreciation in pooled funds, and excessive lending by those in mortgage credit, has precipitated no similar reform action on the part of appraisers. Nor do appraisers have such a mechanism for reform. The lethargy of appraisal organizations to treat methodology as a dynamic evolutionary process of data management and communications could be explained by four major propositions or hypotheses:

1. Suppliers of appraisal services are represented by organizations in which the institutional economics are counter to reform.

2. Consumers of appraisal services may already perceive appraisal models as irrelevant or no longer cost effective in decision procedures.

3. Consumers of appraisal services may have a vested interest in exploiting the potential sophistry of historical appraisal models to arbitrage between models of value for lenders and decision models of value for investors.

4. Appraisers have proven invulnerable to damages caused by their malfeasance and have avoided sanctions instituted by those who regulate financial institutions or administer taxes, so that negative incentives are ineffective prods to improvement.

IV. INSTITUTIONAL ECONOMICS OF APPRAISAL ORGANIZATIONS

The success of appraisal organizations in proselytizing the model that synthesizes the three approaches to value into fair market value has itslf created institutional economic barriers to change. Indeed, the economic self-interest in the status quo of the members in the short run is an underlying cause in appraisal organizational reluctance to research or to advocate significant redefinition, refinement, or endorsement of newer methods. Without heavy pressure from important customer groups to adapt alternative methods, there is a natural inertia of appraisers because:

A. The burden of the financial cost of change inherent in continual reeducation, reprogramming and updating task patterns, and the costs of error inherent in exercising discretion dictates the choice of method, format, and data collection. Certified appraisers fear the effort to re-educate the public will detract from the mystique and status of the designation.

B. Change accelerates the shift of earning capacity from the old to the young, from the intuitive to the systematic, from the experienced to recently trained, and from those who value the profit margins of old methods to those who defer profits for new learning experiences.

C. Marketing appraisal service is more difficult when generic certifications with implicit levels of competence are replaced with a hierarchy of explicit specialties.

D. Costs of malfeasance and malpractice rise with the loss of political collectivization, ambiguity of methodology, and the advent of contracts of engagement that specify elements of performance.

E. Administrators of appraisal organizations lack intensive understanding of appraisal and/or commitment to sustained theoretical development. Given short-term committee leadership of the membership, factionalism by region and specialties, and confusion of appraisal with brokerage and lobbying objectives, natural vested interests of administrators are in noncontroversial business-as-usual.

Certainly, institutional economic incentives are negative in the short run, although the long-term economic justification for independent appraisal is being challenged by encroachments of other specialists in information processing such as accountants, investment management consultants, consulting engineers, and even physical planners. As will be discussed in the next section, there is also lack of recognition among appraisal clientele of the potential relevance and decision value of contemporary appraisal which justifies the learning cost curve and more expensive data models with higher levels of reliability, relevance, and representativeness of real economic behavior. In any event, the appraisal organizations have failed to issue a single position paper on appraisal standards, acceptable alternative methodologies, or caveats when performing appraisals on topical issues of broad concern. Curiously, the recent clarification of market value (11) to require a statement of cash equivalency value, followed by price subject to explicit terms of financing, and the increment in value created by financing, has prompted efforts by some appraisers to squash the clarification. They believe the ambiguity of earlier language was important to the arbitraging of property values through sale of interest by means of syndication. In short, appraisers are not pressed to innovate in the marketplace because consumers of appraisal services have an institutional vested interest in appraisal ambiguity. Of course, those who employ accountants consistently pressure for ambiguity as well, but independent professional guardians of accounting standards have brought to the surface such factors as long-term leases, replacement values of submerged assets, and pension fund liabilities. Accounting, like appraisal, can be undercut by financial institutions. For example, loss reserves for real estate acquired by foreclosure by REITs were to include discounting of future proceeds and outlays at the cost of capital, whereupon the Federal Reserve Board consented implicitly to contingent discount rates of 1% to frustrate accounting reforms intended to remove the water from real estate balance sheet assets.

V. INSTITUTIONAL ECONOMICS AMONG USERS OF APPRAISAL SERVICES

Consumers of appraisal services, specifically those who hire and pay for those services but not necessarily those who integrate the appraisal into their decision process, have always been a force defining appraisal methodology or impeding redefinition and refinement when it suited their short-term interests. Creative contributions to the appraisal process by consumers include not only the origins of the three approaches noted earlier, but standard forms of the secondary mortgage market and private mortgage guarantors, farm appraisal innovations of the farm banking system, and statistical work of the equalization boards and assessment organizations. The federal government has made imaginative, sometimes lyrical, contributions when redefining fair market value to serve its legislative need of the moment (remember urban renewal and fair market value rents in Section 8) so that the word "value" means no more and no less than government chooses it to mean in the Wonderland-on-the-Potomac. However, it is generally more expedient for private parties to exploit existing ambiguities than to legislate and then promulgate self-serving interpretations, pushing them upstream against the institutional inertia of established practice.

Those who purchase appraisal services knowledgeably have generally found it useful to exploit the semantics of appraisals to achieve values supportive of their peripheral objectives. The American business ethic finds it acceptable behavior to shop among appraisers for price and a predetermined bias toward a high or low value conclusion, not to mention editing the final report indirectly by withholding payment for services. To confuse regulatory auditors and income tax collectors, the borrower, his appraiser, and the lender play out an implicit conspiracy that will captalize income from management or intangible assets, such as franchises, as though it were attributed to land and building collateral. The understandable bias of citizens to shift short-term real estate tax burdens toward those with the largest acreages and the tallest buildings is supportive of the assessor's unwillingness to delineate relative contributions to going concern value of land, buildings, tangible personalty, managerial efficiency, financial packages, or other intangible assets that are part of a commercial enterprise utilizing real estate. In short, appraisal has become a significant tool in developing disinformation in communication of value to others. Disinformation is a technique of military intelligence for planting the wrong idea in the enemy decision process by transmitting misleading facts in a format which seems to legitimatize the soure and content. The game of disinformation works best when the stylized codes of the appraisal process are taken for granted as indications of relevance and accuracy by those to whom one is communicating.

Customers for appraisal can be divided among those who have occasional, expensive appraisal requirements and those who can offer a large volume of repetitive, low-fee work. The latter customer can control services through a letter of engagement which prescribes a specified form and procedure. Not only does this apply to class properties like single family homes but to custom properties like apartments and income properties such as controlled by RB 41 (12). The alternative method of control of appraisal methodology is through purchasing power and occurs in such areas as the appraisal of large income properties for pension fund real estate pools. Forty or fifty asset managers control placement of the appraisal business and are organized through the National Council of Real Estate Investment Fiduciaries (NCREIF), the Pension Real Estate Association (PREA), or the National Association of Real Estate Investment Trusts (NAREIT). Asset managers estimate there are no more than 100 appraisal firms throughout the country on whom they rely. Such buying power permits significant definition of appraisal methodology by means of a standardized letter of engagement. Purchasing power concentrated in the hands of such a small trade group can be far more significant than the indirect power of those who regulate and audit financial institutions.

The Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and those who regulate pensions, face a variety of subtle political and cost limitations on their ability to impose reform and redefinition of appraisal practice on thousands of institutions, as a result of failure to use appraisal wisely by a minority of lenders. FDIC AND FSLIC are accumulating hundreds of millions of dollars of real estate which represented collateral overvalued by an appraisal process which leaves little opportunity to assess damages on the incompetent appraiser. Even the effort to require designated appraisers on farm and home loans has faltered since there are not designated appraisers in many small town areas of the United States. Nevertheless, the huge sums of money and critical dependence on appraisal to measure yield and management performance of the private pension asset field will soon lead pension organizations to co-opt control of the appraisal product relative to their area of special interest, just as FHA co-opted residential appraisals for its purposes in the 1930s.

Appraisal as an element of courtroom presentation and social compensation must serve two masters, legal precedent and the practical pressures of justice through advocacy of a viewpoint. Judges are a dominant influence on consumers of appraisal services and have had occasion to see the art of disinformation by the appraisal process practiced in its highest form. Judges prefer to believe that there is a fixed point certainty in values in order that the appraisal become the fulcrum for certainty in values and that the appraisal become the fulcrum for the scales of justice in a way that contributes to an image of decisiveness with equity. Judges are conditioned to accept the ponderous pace of legal precedent and real estate philosophy at the same time they have reason to fear the sophistry of new appraisal techniques which may be introduced to advocate one viewpoint at the expense of another. Nonetheless, better methods of information processing, of forecasting future returns with more than replication of historical evidence, and statistical probabilities of a social process are a threat to judges and property courts. Significant changes in the rules of evidence, the aging, intuitive definitions of value, or the previous precedents are intimidated by the appeal process. Courtroom complexity is squashed by the increasing ability of lawyers to select juries most likely to decide on emotion rather than intellect. The appraisal is sold as a product in which the package has received more thought than the content. The courts, in turn, condition the lawyers and the lawyers, in turn, edit the appraisal process and the admissibility of new techniques. Only a few attorneys can accept the spookiness of an innovative, independent appraisal intellect and at the same time a majority of appraisers advocate that the less the appraiser knows about the legal issues, the better the appraiser can be in his execution of fair market value. Major textbooks argue (12) that the appraiser should not become informed on the law even though the appropriate appraisal model must be chosen to relate to the issue under litigation. Lawyers perceive an appraisal to be cost effective when it is an advocate, or do not believe the appraisers can be cost effective in defining the information to be communicated in the litigation. The costs of stereotyped courtroom appraisals, missed opportunities to use cross-examination of the charlatan appraiser to achieve equity, and unnecessary litigation occasioned by erroneous appraisal viewpoints and precedents must be staggering. Ironically, lawyers remember the cases they won by exploiting the weaknesses of the appraisal process, and judges recall with favor those cases in which the appraisals were stereotyped by precedent and sterile in terms of technique.

The ability of consumer groups to impose the economics of their self-interest on appraisal doctrine and technique and on the many well intentioned appraisers who have eschewed court work, mortgage loan appraisals, or syndication work is the direct result of impotent professional organizations. Independent arbiters of appraisal practice do not exist to function in a manner parallel to the partially successful models of the accountants, the engineers and the doctors.

VI. INSTITUTIONAL VACUUM: APPRAISAL ORGANIZATIONS

The inherent weakness of appraisal organizations historically has permitted the consumer of appraisal services to co-opt the process of defining appraisal procedure to the long-term disadvantage of social equity. Purchasers of appraisals, which are required by lenders, prospective purchasers, or regulatory agencies have the ability to intervene in the control of appraisal information because they select and pay the appraiser. There is seldom any blatant subordination of the appraiser, and the audience for the appraisal report reserves the right to reject or limit selection to an approved list. Nevertheless, those who sign the check maintain the subtle ties of reciprocity in the American business scene which influence the appraisal process through Veblen's "insensible bias of position." There is virtually an identity of interest between the appraisal, financial, and real estate brokerage fraternities to oversimplify appraisal concepts in order to frustrate regulatory objectives. Loss of economic independence and responsiveness to economic pressure from those who are repeat customers for services has diluted appraisal objectivity and undermined perceived cost/benefit ratio of rigorous appraisal among consumers of appraisal service.

Failure to advance recognized appraisal procedures to encompass contemporary techniques and problems and failure to retain control of standards has resulted in some appraisal consumer groups perceiving that better appraisals, perhaps at higher cost, are irrelevant to their decision procedures. Weak appraisal organizations make it impossible for those with reason to doubt appraisal performance to secure efficient and effective sanctions against the incompetent. Weak appraisal organizations are not effective conduits for public auditing and monitoring agencies to advance appraisal standards to serve the ultimate user who must rely on appraisals paid for by the regulated.

A variation of Gresham's Law is operating so that superficial and cheap appraisal products are supplanting intellectually intensive and more expensive report models. Weak appraisal organizations which are unable to apply strict standards on their membership lose public respect for the appraisal process so that:

1. University faculties ignore appraisal as an important area for research of cost effective methodologies.

2. Monitors of financial failure believe it futile to catalog the costs of appraisal failure leading to investment errors.

3. Voters seek alternatives to taxation based upon real estate values rather than increased public expenditure for improved methods of mass appraisal.

The individual appraisers who represent the best in technique, personal skills, and contemporary thought, are frustrated by the committee process of the appraisal organization, the compensation pressure of the consumer, and the absence of promulgated methodologies from those who audit or monitor the public interest. The aggregate consequences of the discouragement of the earnest and the cynicism of those who benefit from the current state of affairs is that the subject of appraisal lacks sufficient status to attract research funds of sufficient scale so that the cost/benefit advantages of redefinition, reform, or even strict policing of present processes could be demonstrated. Such a demonstration of public benefit must precede effective action by the quasi-public agencies which have positive economic incentives to intervene in the evolutionary development of the appraisal process.

VII. INSTITUTIONAL ECONOMICS FAVORING CHANGE

It has been argued that economic motivations for broader concepts of valuation in the style of Ratcliffian contemporary appraisal are negative in terms of both traditional appraisal organizations and the majority of financial and tax institutions which generate effective demand for appraisal services. However, there are two institutional forces at work which could bring about recognition of more sophisticated, contemporary appraisal assignments and techniques. First there is the national tendency to disaggregate from monolithic organizations, spotlighted by

Naisbitt in MEGATRENDS, a trend manifested by participatory rather than representative government, specialization of media in terms of topic and reader profile, federation of business departments rather than monolithic conglomerates, and a variety of other manifestations of clubbiness at the local level. At the very time that the major appraisal groups are once again considering merger with only lukewarm enthusiasm among the membership, the institutional trend suggests that what is needed is a federation of appraisal interests grouped or structured by specialties. Just as the Urban Land Institute is organized around nine councils of special development topics, perhaps a single national federation of appraisers should be organized in councils which focus on specific interests such as these found in the left hand column of Exhibit 5. A federation of councils on valuation specialties like those in Exhibit 5 would provide a common base of principles, enforcement of ethical codes, representation in legislative halls, and administrative support. Each council could focus on appraisal techniques and standards germane to their interests without the impediment of educating the other ninety percent of generic appraisers as to the technical justification for departure from normative formats.

Each such council would interface with a regulating framework where social equity and institutional security would be a positive economic incentive to implement improvements, redefinitions, and more far-reaching reforms for the appraisal process. A representative identification of those representing the public sector is provided in the right hand column of

EXHIBIT 5

A PRELIMINARY SUGGESTED SET OF APPRAISAL COUNCILS
REPRESENTING FEDERATION OF APPRAISAL USERS
WITH POSITIVE ECONOMIC INCENTIVES FOR APPRAISAL REFORM

Appraisal Council Specialties on the Supply Side	Agents of Appraisal Reform on the Demand Side
1) Residential for finance and tax assessment, RM, SRA, IAAO	HUD, HLBMC, FNMA, FSLDIC, PMI, and state housing agencies
2) Appraisal of income properties as collateral for mortgage loans and security financing	SEC, CPA, MBA, ABA, and FSLDIC plus IRS
3) Appraisal of industrial process properties	Council of Economic Development, SEC, GSA
4) Tax assessment appraisal of commercial properties	IAAOP, AIP, state boards of equalization
5) Appraisal of land and mineral resources	Department of the Interior, The National Park Service, the National Fish and Wildlife Service, and GSA
6) Appraisal for planning and eminent domain	The AR, HUD, and the National Board of Transportation
7) Appraisal of real estate equity pools	ERISA, PREA, NCREIF, and NREIT
8) Appraisal of personal property, including arts, jewelry, and intangibles	IRS, NBFU
9) Appraisal of machinery, transportation equipment, inventories, etc.	IRS, NBFU

Exhibit 5 and in some cases these agencies are already beginning to operate with a de facto set of councils or specialties.

Early in the essay, institutional economics was defined as studying how associations of persons operated collectively so that their behavior could be modified collectively. An illustration is the area of real estate for investment purposes of private pension funds where appraised value plays a major role in measuring the adequacy of funds provided, as well as the performance of asset managers, in terms of yield on capital employed. On the one hand, government is represented by both the IRS and those administering the Employees Retirement, Insurance & Security Act (ERISA). Both are introducing sanctions and financial penalties for gross appraisal error or "aggressiveness" in advancing client interests. The dominating pension asset management teams are represented by the Pension Real Estate Association (PREA) and The National Council of Real Estate Investment Fiduciaries, (NCREIF), both of which are investigating use of a standard letter of engagement controlling definition of appraisal methods, assumptions, and responsibilities to the fund managers. There is an obvious common interest between those who would apply government sanctions and those who would apply consumer standards on the practice of appraisal for pensions. Both of these latter organizations agree that there are a limited number of appraisal firms which are considered qualified to set pension asset values, a number too small for a generic organization to police. The appraiser, in turn, needs support from the accountant in defining acceptable income forecasting methodology. The accountants have already begun, through the

FASB, to review and to standardize generally accepted principles for real estate accounting that could impact appraisal at every level.(12) At this point appraisers do not agree whether the income approach to valuation should reflect cash or accrual accounting, stabilized or inflationary rollover rents, and current or existing financing on the property. Nevertheless, the institutional self-interest for establishing standardization of the appraisal process exists both on the public side in terms of the ERISA guarantees of funding, much like FDIC guaranteed bank deposits, and on the private side where asset managers must maintain credibility as well as a basis for comparative competitive performance. The result will be a council of appraisers with special accreditation procedures who are acceptable to both the public and private sides of the pooled equity fund industry.

At the opposite end of the spectrum from large income investment properties is the accelerating movement to adapt the mini-computer to processing of residential mortgage loan appraisal and assessment valuations. As in the pension scene, there are monolithic federal agencies with an immense interest in the reliability of asset value estimates including FNMA, FHLDMC, GNMA and FSLDIC who are moving toward a consensus on appraisal content, format, and reliability. Standardization and computerization of the appraisal product also serves their actuarial approach to investment and underwriting risk. At the same time there are pressures at the state level to automate residential tax assessment, reducing the vaguaries of the local art form of assessment and the statistical crudities of equalization. Both investment stability and social equity are lending to some sort of accreditation of appraisal firms which understand the opportunities and pitfalls of set theory and statistics in the valuation of small residential property.

As much as academics would like to believe that intellectual elegance and work quality are sufficient motivation to move a professional group forward, the fact is that improvements in technique occur only when social institutions become self-conscious about the inadequacy of a procedure because dissatisfaction makes the benefits of improvement apparently greater than the costs of implementation. We believe the route to significant updating of the appraisal process and broadening of the official metaphysical base will occur if academics and public regulators educate and coerce the users and consumers of appraisal services to demand more of appraisers. Indeed, one could hope that by provoking ERISA and PREA to introduce a standardized appraisal methodology for income properties enforced with a letter of engagement, we would eventually goad the appraisal organizations into a creative flurry of more far-reaching reforms in order to reassert their domain of authority. A similar drama has already been written in the effort by the SEC in 1974 to reform inflation accounting via ASR 190 (13) which provoked the much needed, long delayed response by FASB and accounting academics, the FAS 33 as amended by FAS 41, and continuing waves of research on how to report value of business real estate assets. This colloquium is reaching the wrong audience and the next effort should focus on pension fund real estate or automated residential appraisal, theory and practice in order that contemporary appraisal proponents or gadflys can convert a sting on the rump of the appraisal herd of content bovines to a painful spur causing a stampede of ERISA bulls.

FOOTNOTES

1. John Naisbett, MEGATRENDS (Warner Books: New York, 1982).

2. Finance Accounting Standards Board Report 33, in response to SEC Accounting Report 190.

3. SEC Accounting Report 190.

4. The Appraisal of Real Estate, Eighth Edition (Chicago, IL: American Insitute of Real Estate Appraisers, 1983).

   The flyleaf of the eighth edition says: FOR EDUCATION PURPOSES ONLY. The opinions and statements set forth herein are those of the individual members of the Institute's editorial staff and do not necessarily reflect the viewpoint of the American Institute of Real Estate Appraisers or its individual members.

5. The following was quoted from "Institutionalism and Urban Land Economics," in Richard U. Ratcliff, Recent Perspectives in Urban Land Economics (Vancouver: British Columbia, University of British Columbia, 1976).

   "Professor Edwin Witte was a labour economist trained by Dr. Richard R. Ely. He was a Wisconsin institutionalist, one-time president of the American Economic Association, and expressed the essence of institutionalism so reasonably and so lucidly that since his essay was published in 1954, his has been my final authority. Here is my interpretation of Witte's views on institutional economics:

   1) It is not a complete, self-contained and connected body of thought, but a method of approaching particular economic problems.

   2) It is problem-oriented economics.

   3) Its concerns are more than solely economic motives and thus include whatever leads man to act in economic matters.

   4) It is interdisciplinary in recognition of the broad range of interacting social and technical factors which affect economic affairs.

   5) It recognizes that the institutions which are active or which are restraints in our economy are man-made and changeable. In problem-solving, it is the present form

of the institution and its evolutionary origins which are the materials of analysis.

6) The method is heavily inductive, based on a direct observation of all the facts.

7) It comprehends the associational aspects of our society which lead to group patterns of thinking and action."

6. The FHA was responsible for creating a more rigorous single family home appraisal process; the Home Loan Bank took a firm stand against the excesses of the Ellwood approach when appraising income properties for loan collateral value; the California Board of Securities first established controls on computerized cash flow forecasting to estimate investment value of real estate in a prospectus. Watch the SEC and ERISA as they bring real estate value determination under control in their respective fields of interest.

7. See Chapter 3, "Analysis of the Appraisal Process as Applied to Land Corridors", by Terry V. Grissom, an unpublished Ph.D. dissertation at the University of Wisconsin-Madison in January 1981.

8. Statement of Financial Concepts, No. 2, Qualitative Characteristics of Accounting Information, p. xxi.

9. See the definition of the implicit conditions in fair market value on p. 33, The Appraisal of Real Estate, Eighth Edition (Chicago, IL: American Institute of Real Estate Appraisers, 1983).

10. Ibid.

11. The Federal Home Loan Bank has developed a very explicit set of auditing rules, R 41B "Appraisal Policies & Practices of Insured Institutions & Service Corporation."

12. See Chapter 1, Real Estate Valuation by Litigation, by J. D. Eaton (Chicago, IL: American Insitute of Real Estate Appraisers, 1982).

13. The FASB began to address certain parts of the real estate value problem in 1979 by means of the requirements of SFAS 33, later amended by SFAS 41. Currently the AICPAs real estate accounting committee is undertaking an experiment on the application of current value accounting to the financial statements of real estate companies. As reported in "Real Estate Financial Reporting: User's Perspective," by Michael J. Brenner, The CPA Journal, Spring 1984, pp. 32-35.

14. The SEC was the first policy-making body to require disclosure of inflation-adjusted financial information with regulation S-X, amended by rule 3-17, with the disclosure requirements set forth in Accounting Series Release #190,

(ASR 190) on March 23, 1976. In September 1979 the Financial Accounting Standards Board (FAS) issued a counter statement on "Financial Reporting and Changing Prices" (FAS 33) which essentially replaced SEC requirements and re-established FASB turf after a long period of dilatory delay on reforms required.

THE NEED FOR REDEFINITION AND REFORM OF THE APPRAISAL PROCESS

A Sentence Outline of Introductory Comments
To the Appraisal Colloquium at the Lincoln Institute
June 1984

By Professor James A. Graaskamp

I. The appraisal function and methodology are pivotal to decisions involving social equity and efficient allocation of capital on a vast scale.

A. The first imperative is the necessity of ethical institutions which are sensitive to the responsibility of their social functions. Social equity is becoming more complex, and therefore valuation models require continual redefinition to allocate real estate taxes, income taxes, available mortgage capital, and eminent domain compensation. Land ownership is a trusteeship and as the public reasserts its control over historical private rights financial reimbursement depends on sound valuation procedures.

B. Capital is also a trusteeship and the malfunction of appraisal in defining collateral values and real estate feasibility can result in great economic losses to existing financial institutions. These institutions are really congregations of individuals with whom the appraisal profession has a social compact to do the best professional work possible.

C. In addition to validation of institutional collateral, appraisal serves to benchmark the performance of assets and asset managers. To the degree that its methods fail to use the best forecasting techniques available, appraisal contributes to the misallocation of capital and the short-changing of those enterprises that might otherwise have been financed to the social benefit of all.

D. The failure of the professional appraisal organizations to advance standards or even issue position papers on innovative techniques or issues raised by contemporary appraisal assignments is first a crisis in business ethics and secondly a frustration which drains the best talent and most creative energies away from further contributions to a professional appraisal group.

II. Appraisal functions and methodology are a specialty in the larger discipline of information processing and decision making, a field which has been moving forward at an accelerating and exhilarating pace. Information processing and therefore appraisal procedure always requires some structure or model with which to qualify, edit, format, and focus data with relevance to a problem or decision. Such models have six constraints and current appraisal thinking is failing to accommodate any of the six:

A. Definition of the issue or question for which value is required as a benchmark is seldom correlated to the definition of value or legitimate conditions to the value conclusion. The market value required to define liquidating value of a pension fund is not the same as market value required for eminent domain or market value required to collateralize mortgage loans, assess taxes, or compare asset managers.

B. Recognition of data with relevance to the issue is continually shifting as the market comparison method suffers from engineered prices, data processing permits cash flow forecasting, and physical replacement costs shrink as a proportion of project loss. Nonetheless, appraisal organizations have not issued a single white paper as to their positions on a merging methodology and disavow their own textbooks as statements of policy.

C. Identification of hypotheses which focus data on the issue is regarded as suspect when practiced by the appraiser using statistical inference, simulation models, or even financial instincts developed in non real estate fields.

D. Credibility and skill levels of the analyst limit the choice of models. The appraisal organizations of their best members have failed to disseminate the brilliant innovations of the best for simulation by the typical analyst. Professional discipline and incentive to acquire new skills is weak due to the institutional economics of the field.

E. Acceptability and credibility of a model with a decision maker greatly affects his perception of the analyst. Sophisticated decision makers perceive simplistic appraisal models and deductive formats of the 1930's as characteristic of the mind set of the appraiser and therefore the minimal use value which can be accorded the appraisal product.

F. Use of a model for information processing to be cost effective in terms of focusing data in a timely fashion without significant bias toward an error of economic significance. Given the explosion of urban land data and the falling costs of data processing, how does one explain the rigidity of appraisal models developed for simple questions, a shortage of data, and some questionable hypotheses as to how that data should be adjusted to fit the problem at hand.

III. The traditional real estate appraisal model using the three approaches to value and the format prescribed for a narrative appraisal report has been so firmly implanted in the minds of both appraisers and consumers that it has been easily formatted for word processor and printed forms for repetitive application to all types of property. As a result appraisal form does as much for credibility as the substance of the report content. More often than not, the relevance of form is not matched to the issues for which appraisal is sought and appraisal consumers speed-read the letter of transmittal with a value conclusion and the picture pages of comparable sales.

A. The conditioning of the appraisal market to format, and terminology by rote has made the appraisal process a prime tool in the art of disinformation. Disinformation is a technique from military intelligence which attempts to mislead the enemy by communicating information in a media format which gives it credibility or inferences which are not appropriate. The fair market value appraisal has become the tool of the borrower, syndicator, or deal maker for misleading the investor or those who regulate the financial enterprise. Indeed, there is an implicit conspiracy between the appraiser and his client which tends to polish the appraisal art form as a device for disinformation. The Bar Association has found it necessary to create a special canon of ethics which prohibits lawyers from using appraisals where the appraisers lack proper qualifications and the conclusions fail the test of reasonableness. One legal writer stated, relative to appraisal, that "purposeful naivete" on the contents of appraisal is tantamount to constructive fraud. The 1984 tax law provides sanctions against appraisers whose values are considered "aggressive" under IRS court challenge and these sanctions are to be 30% of the income tax savings which would have resulted from the appraisal distortion. Needless to say, this tendency of appraisal to be used for disinformation purposes seriously undermines the credibility of the process and the ability of legitimate appraisers to charge fees appropriate to the cost of professional and objective work.

B. Given the fact that appraisers have been implanted with a given format by their professional training, the cost of redefinition and reform of techniques and communication methods falls on the individual appraiser. Costs include reeducation fees, the opportunity costs of time dedicated to continuing education, the inefficiency of changing work patterns, and the costs reeducating the customers. Moreover, there are many customers who can exploit the current format and would boycott objective, analytical appraisers. For the established appraiser there are many disincentives for changing his modus operandi while the young appraiser lacks the credibility required to introduce innovation via the appraisal report.

C. The ultimate cost of appraisal reports as media for disinformation is shifted to all of those who pay their debts in the form of higher interest costs, higher guaranty fees, and the failure of lending institutions at the expense of the FDIC and FSLIC. The losses are not specifically pinpointed to appraisal malfeasance nor do they fall on an identifiable political constituency. As a result the cost benefit ratio to the public is kept vague and insufficient to cause a public investment in the appraisal reform for which individual appraisers have no economic incentive. IRS sanctions in the 1984 law do not place the full cost of disinformation on the appraiser and may only receive court support if appraisal is 200% of what is determined to be market value. A tacit implication that error of less than 100% can be expected in an appraisal should be an embarrassment to current standards.

D. The ethics of disinformation are also hazy since American business condones the use of misinformation where it is provided by a third party to frustrate the objectives of public regulation. The ability to follow regulations in form rather than spirit is a part of American business knowhow so that most appraisers receive peer group approval for shoddy or superficial appraisal work.

IV. The increasing exposure of American financial institutions to the risk of commercial real estate investment is the subject of much publication. These sources of expensive funds generate an oversupply of space and accelerated obsolescence on older locations and structures. Collateral values on new properties are suspect and are diluted on older properties. Tremendous losses accumulating at FDIC, FSLIC, ERISA, and SBIC will generate several alternative scenarios to reform and redefine the appraisal process:

A. Federal regulators of financial institutions will retake direct control and responsibility for the appraisal function of income property, such as reemphasis on R-41(b) or IRS sanctions and rules.

B. Customers for critical appraisal services, such as asset managers of pension funds, will take explicit action by developing a standardized letter of engagement controlling appraisal methodology for their members. PREA, the attorneys who provide tax counsel and others are moving toward the detailed engagement letters developed in Europe with input from Royal Institute of Chartered Surveyors.

C. The appraisal process will become a specialty within larger information processing fields like accounting, investment banking, or physical design where professional credibility already exists. Firms in each of these fields already have appraisal divisions, some of which avoid professional appraisal designations as a matter of policy.

D. Appraisal standards and definitions will be imposed by a federation of existing financial monitoring groups controlling acceptable methods and definitions for both collateral values and investment performance measurement. National residential brokerage chains have their own definition of market value which deducts for costs of redecorating, a value they call fair market value with impunity.

E. Existing appraisal organizations which are generic and non-specialized will reorganize as a single federation of appraiser/customer groups of common interests in a mix private/public consortium to negotiate appraisal redefinition in the immediate future.

F. It is our position that the last scenario is the most desirable resolution but the most difficult to accomplish with speed, objectivity, and imagination. It offers the hope that professional control of appraisal will survive outside a federal bureaucracy or the control of accountants and investment bankers where advocavy of client and consultant self interest has its own history of ethical failure. Scenario E should permit valuation to survive as an economic function, an independent thought process, and a profession although it will come at the cost of the evolutionary demise of generic appraisal organization and generic formats.

V. Underlying these comments is the hope, nay, the position of the speaker, that it is best for the social and business ethics of our society, as well as the remaining vestiges of a price economy, that appraisal survive as an independent field of expertise, practiced by generalists who maintain empirical objectivity in the process of valuing the facts and assumptions provided by specialists. However, the time remaining for redefinition, reform and reenergizing thoughtful, independent appraisal is rapidly disappearing as evidenced by:

A. The trend for high volume, low unit price appraisal work for residential properties is becoming automated, perfunctory, and in the nature of a physical audit. There is a growing suspicion that single family residential family appraisal is less cost effective than statistical toleration of variance in a mortgage portfolio with the result that a significant component of the appraisal business will be reduced to spot checking of values and of properties falling outside some standard classification.

B. At the same time high fee appraisals, with lower unit volumes, are shifting toward execution by nationally known accounting firms, investment banking subsidiaries that have inside information on market comparables, and real estate research firms who have proven their willingness to collect market data.

C. Much of the remaining volume of appraisal work in traditional form are required only to satisfy regulatory audits and fiduciary liability. Obsolete court perceptions and precedents relative to appraisal cause old appraisal definitions and format to survive well past their useful life. These negative incentives for appraisal and the boredom most judges show for valuation testimony is a precursor to society dispensing with independent appraisal altogether in order to find pricing agencies which will better serve social equity, efficient capital allocation, not to mention more straightforward presentation of evidence in court.

Final Conclusion

All of the forces for redefinition and reform of the appraisal process and its role in decision making are already at work to overcome deficiencies of the traditional appraisal process. The problem is these agents of change are principally external to the appraisal profession, and the urgency of this colloquium is for the appraisal profession itself to regain control of its modus operandi and its historical evolution.