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Not Just Any Appraisal Will Do

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Not Just Any Appraisal Will Do

By Rachel E. Fisch, CPA/ABV, MRICS and Stephen King, MAI, MRICS
RealAdvice, Tampa, Florida

When serving clients in matters in which significant real property is being conveyed, asset valuation frequently requires determination by properly licensed professionals. When the real property is commercial (income-producing), an additional, and frequently overlooked, valuation skillset is required. Thus, professional competency becomes paramount.

While it is always important to research service providers before engaging anyone's services, researching the quality of their services is even more important when relying on providers for their professional advice in matters of finance and business. Before the advent of the internet, professional service reviews were primarily communicated by word of mouth. So, while the internet has simplified the process of finding credentialed professionals, how does one determine if the valuation expert found to allocate the purchase price on a commercial real estate transaction is providing the best possible service?

This article provides specific insight on how to determine if the valuation expert that you hire to prepare a purchase price allocation report for commercial real estate is rendering the most defensible opinion report available. Simply put, it is of paramount importance that a state-of-the-art report will be prepared and signed by a multi-disciplinary team of experts both in real estate *and* in business valuation.

What is a Purchase Price Allocation?

It might help if we first take a step back and define our terms. The Financial Accounting Standards Board (FASB) defines a business combination as a transaction or a process in which two or more separate businesses or entities come together to form a single entity. These combinations are, typically, undertaken for various strategic, financial, or operational reasons and can take several forms, including mergers, acquisitions, consolidations, or joint ventures.

Purchase Price Allocation (PPA) is described as the process of taking the total consideration paid in a business combination and dividing it, but that's not technically correct. The PPA process involves identifying both the assets, including intangible assets, and also the liabilities acquired and determining each one's fair value.

> Fair Value, or Fair Value Measurement is not the same as Fair Market Value. FASB 805-10-20 defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Fair Market Value, on the other hand, is defined by the Internal Revenue Service in Revenue Ruling 59-60 as, "the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Why would we need to determine Fair Value? A PPA is relevant in the acquisition of commercial real estate because the buyer acquires a going concern, a business operating on and in a parcel of real estate. In 49 states (excluding Mississippi), intangible assets are not taxable when conveyed as part of commercial real estate. That said, invariably, there are intangible assets associated with commercial real estate, such as workforce (payroll), intellectual property, unamortized lease

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costs, and tenant relationships. These intangible assets are often significant components of the purchase price of what is commonly thought of as only real property.

A Little History

How did the process of allocating purchase prices come into being? Before June 2001, a business combination could be accounted by using either the "purchase method" or the "pooling of interests method." However, application of these two methods could result in very different financial statements for the same transaction. In 2001, for increased transparency, the Financial Accounting Standards Board (FASB) released Statement of Financial Accounting Standards (SFAS) Nos. 141 and 142. These standards required that business combinations be accounted for using the purchase method. The increased transparency is for all users of the financial statements, which includes investors, stockholders, lenders, and others. A revision was issued in December 2007 for additional clarification. In 2009, these standards were codified in ASC 805.

Applying the "pooling of interests method," the balance sheets (assets and liabilities) of the two companies being combined were simply added together, item by item. Any premium paid over the historic cost of the assets was not reflected in the financial statements. Shareholders did not have a clear understanding of the value of the business being purchased. With the introduction of these standards, businesses were required to identify the fair value of the assets obtained and the liabilities assumed in a business combination, including intangible assets and goodwill. An allocation of the purchase price is now required.

What Should I Look for in a Best-in-Class Report?

If a service provider offers to perform a PPA for a commercial real estate transaction, ask to see a sample or a redacted report already produced by that service provider. Review it to determine if it meets the standards that govern both the

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process and the methods used to determine the fair value of intangible assets, such as those that follow.

The report should disclose appropriate assumptions and limiting conditions and that the analysis was performed subject to these factors and constraints. They are common in valuation engagements and are often listed in an appendix. These disclosures should clearly delineate the information relied upon and should specify what the valuation does and does not claim to do.

An overall description should be included in the introduction or the overview of the report. It should include a clear definition of the valuation assignment, as well as the following:

- The identification of the subject property by address, parcel identification number, or coordinates.
- The purpose of the assignment, with an explanation of why the valuation specialist was retained. This should be clear and provide that its findings are not to be used for any other purpose.
- The valuation or measurement date, i.e., the PPA for a commercial real estate transaction is the closing date.
- The standard of value. This will generally be fair value as defined in ASC 820 or a legally mandated standard required in the situs jurisdiction.

Restrictions on the use of the report for the intended purpose should be noted early in the narrative. Valuation of the intangible assets is performed for the purpose articulated in the report. Using it for fundraising, lending, or any other purpose would likely be inappropriate. Such uses would require additional or different analyses.

The valuation date is specific to the PPA and could vary depending on the purpose of the report. If a valuation is performed when there is an acquisition or exchange of commercial real estate, then the date should be on or near the date of the acquisition. A PPA could also be performed when the county assessor reassesses the property. A reassessment is based on a hypothetical transaction. For this situation, the appraisal valuation date would be the date of reassessment.

Best practices for a PPA report include a list of source documents the analyst appraiser(s) relied on to complete the analysis. The reliance on variable data sources should be clear, indicating whether it is derived from empirical data, assumptions, or the analysis(es) of the appraiser(s). If a multidisciplinary approach is used, the analysis will be performed by more than one appraiser.

Financial performance and cash flows are relevant to the valuation of intangible assets and substantiate the plans for the acquiring company. Whether the financial information relied upon was or was not audited, reviewed, compiled, or attested to by the valuation analysts, this should be stated in the report. The financial data relied on should be provided, in detail or summary form, in the body or an exhibit to the report.

A PPA report will contain the representations and qualifications of the valuation analyst(s). It summarizes the factors that guided their work during the analysis. It contains

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the explanation of the authoritative guidance used for the analysis and the report.

So, how does counsel determine which valuation experts are best equipped to prepare the report described above? Such an analysis must be performed by multidisciplinary experts in both real estate (i.e., an MAI designated appraiser or equivalent) and a business valuation (i.e., an ABV designated appraiser or equivalent), using the PairedExpert™ approach or an equivalent technique. Ideally these experts will have vast experience in their respective fields of expertise, separate from providing opinions on a commercial real estate PPA.

Best-in-class reports present multiple valuation approaches and methodologies properly considered and used as stated within the narrative. The techniques used to value the assets must be professionally accepted in each of the fields (business valuation and real estate appraisal). Methods used to determine the fair value of intangibles assets will be in alignment with accounting rules and standards. The conclusions rendered must be internally consistent, mutually supportive, and cross-tested.

How Do I Know If the PPA Report I Have is Preeminent?

A state-of-the-art report will contain a narrative that explains the valuation issues relevant to the specific conveyance. The writing will be in clear, professional language and will reflect the economic reality of the acquisition or the disposition. Technical terms are defined. This is critical as different states, the Internal Revenue Service, and even various accounting bases contain more than one definition for the same term. Clearly defined terms eliminate any possibility of confusion.

Because PPAs are developed for the purpose of determining the price that would be paid for component assets by market participants, the documents and factors used to determine fair value must be those that are available to them. The analysis will exclude strategic factors from the appraiser's analysis and report findings.

The reader of the report should have a clear understanding of each intangible asset valued, its relevant technical guidance, and how it contributes to the commercial real estate's going concern value.

The report should contain a summary of the transaction and convey that the valuation specialist has knowledge of the deal terms and the impact of those terms on value(s). Terms that carry significant value implications should be discussed in the report.

In its closing, a preeminent report will provide an explanation of the overall reasonableness of the allocations. It will present both a qualitative assessment and a quantitative analysis. It will also present how the valuation of each asset in the allocation supports the total value of the commercial real estate as a going concern.

A preeminent report appropriately describes the opinion(s) of value of the appraiser(s) for all identified assets and liabilities. These should be opinions of the legally appropriate values at issue. Appraisers do not determine values; the market does that. Appraisers opine.

The report should not imply a false level of precision; appraiser(s) should apply a consistent level of mathematical rounding throughout the analysis and within the report. Each method or value indication will be consistent for each asset and liability as well as the final conclusion.

Conclusion

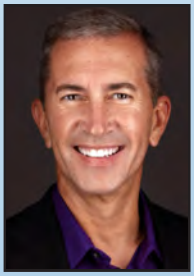
A best-in-class and state-of-the-art purchase price allocation report for a commercial real estate conveyance will properly address all of the variables discussed above and will be prepared and signed as a single report by a multi-disciplinary team of experts in both real estate and business valuation. This is why the PairedExpert™ approach by RealAdvice will always provide you with a best-in-class report.

R. FINCH

Rachel Finch *has been a CPA for over twenty years with a focus on business valuation, consulting, and forensic accounting. She has handled over 200 forensic and valuation matters, including Ponzi schemes and embezzlement cases. She has testified over 20 times without being appealed, being recognized as an expert in numerous court jurisdictions for her analytical and valuation skills.*

A member of two different motorcycle crews (Stilettos on Steel and Diva Angels), Rachel is also an adventurer.

She is a Senior Managing Director in charge of business valuation at RealAdvice. She is an expert in the valuation of intangible business assets.



S. KING

Stephen King *has been appraising commercial real estate for over 20 years, conducting valuation assignments on property types that include multi-family, hospitality, industrial, office, retail and student housing. He is a Member of the Appraisal Institute, one of the highest distinctions in the industry, as well as a Member of the Royal Institution of Chartered Surveyors.*

Stephen has over 10 years of experience as a Special Magistrate, conducting and making recommended decisions in hundreds of Value Adjustment Board hearings, all of which were upheld.

He is an Executive Managing Director at RealAdvice where he is in charge of property valuation and oversees the production team. He's a state-certified general appraiser in Florida and in nearly 40 states around the country.