SBA, SOP and Business, Real Estate and Going Concern Appraisals Controversy or Opportunity?

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Introduction

The current SBA policy document related to real estate and business acquisition loans is generally referenced as **"SOP 50 10 5(F)"** and is titled **"Lender and Development Company Loan Programs".** As most industry participants know firsthand – and to the credit of the SBA - the SOP 50-10 series has evolved substantially during the past five years with certain changes related to business or real estate valuation requirements among the most important.

In day to day practice, the most direct coverage of real estate "appraisals" and business "valuations" as they apply to Section 7(a) business loan programs is found in:

> **Subsection C** (***Appraisal and Business Valuation Requirements/*****page 171**)
> Of **Section II** (Collateral/**page 168**)
> Within **Chapter 4** (Credit Standards, Collateral and Environmental Policies/**page 161**)
> Of **Subpart B** (Section 7(A) Business Loan Programs/**page 71**)

As an aside, note that **Subpart C** (Section 504 Certified Development Company Loan Program/**page 236**) addresses the **financing of fixed assets including land and buildings** (real estate). Subsection A of Section II (***Appraisal Requirements/*****page 290**) addresses requirements for "commercial real estate" lending in a manner that is almost fully consistent with the coverage that begins on **page 171**.

Returning to **Subpart B**, the Appraisal **and** Business Valuation Requirements are addressed beginning on page 171 of **Subsection C**. It is SBA's chosen nuance to refer to **commercial real estate as requiring an "appraisal" whereas a business requires a "valuation".** This choice is not grounded in any particular set of professional standards, but has been somewhat consistently used throughout the years within the SBA community. This bifurcated terminology is the tip of the iceberg when it comes to identifying possible areas for improvement in the administration of real property and personal property appraisals.

A few years ago, my colleagues (lenders and appraisers) and I floated a recommendation to fully separate the real property appraisal requirements from the business or personal property valuation requirements. It makes a good deal of sense to treat these two realms separately just as they are handled professionally, i.e. real estate appraisers can be state-licensed and are uniquely trained relative to business appraisers (and vice-versa). ***Besides separating the two realms, we put forth several specific recommendations on the business valuation side which were partially accepted but largely put aside.***

One example of the confusion which still exists is the role played by USPAP in business valuations. While some accreditation groups require USPAP compliance, others do not. The

SOP 50-10 references (mandates) USPAP requirements when discussing real estate appraisals, but NOT when discussing business valuations. Not only should USPAP be specifically identified as the required professional standards for business valuation engagements, they are in fact already legally mandated via the **Code of Federal Regulations** (as per **section 564.4 of Title 12 and other sections, as presented shortly)**.

One of the positive changes implemented was the institution of the invaluable requirements that a business appraiser be certified via one of the top BV credentialing organizations and "regularly receive compensation for business valuations". There have been ***a series of iterations*** in this regard with **CPA's** once allowed but now disallowed (unless they have one of the qualifying BV credentials) and **AVA's** once not allowed but currently allowed. **Most recently, a change involving the "going concern" appraisals and appraisers has ignited confusion and controversy** which has been the topic of the Senate Confirmation Hearings for Maria Contreras-Sweet (Administrator of **SBA**) and debate among lenders and appraiser groups alike as to who can perform these unique assignments involving both real and personal property.

Despite the extra attention and definite improvements implemented since 2008, the bottom line is **that there is still a great deal of uncertainty among lenders and appraisers alike with respect to various key components of the SOP 50-10 (5)(F) policy and what is proper and acceptable for the ultimate purpose of sustaining the pivotal "guarantee"** which accompanies SBA loans. The overall impact of such uncertainty ultimately includes the delay or outright avoidance of completing the loan process to the detriment of our nation's smallest but job-creating enterprises.

To complicate matters, the **ultimate or source regulations** governing all SBA appraisal requirements are set forth in the Electronic **Code of Federal Regulations within Title 13 (Business Credit and Assistance)** and **Part 120** (Business Loans). Less frequently cited is the connection to **Title 12 (Banks and Banking), which lays out requirements pertaining to "federally related transactions"**. As shown later, it is Title 12 which provides the strongest support for business appraisers following Uniform Standards of Professional Appraisal Practice or USPAP.

At the same time, business and real estate appraisers must adhere to **one or more sets of their own "professional standards" beyond USPAP –** all of which can be "overwritten" by actual SBA policy due to the "jurisdictional exception" rule that permeates such standards. This rule is potentially very important as it ***allows the SBA (federal government) to clarify its definitive preferences with respect to what a "qualified appraisal" might or should contain,*** i.e. the SBA has the authority to direct the herd in a uniform direction to the benefit of all concerned parties.

What type of policy changes would benefit the SBA community? At the broadest level, simply clarifying that all business valuations must be prepared in **conformity with USPAP** would eliminate wide and deep swaths of potential confusion among appraisers today. Equally important are issues such as **"qualified appraiser" criteria**, both in general and most recently as it pertains to the valuation of so-called "special use" or "mixed use" or "going concern" appraisals.

Why USPAP?

Although there are material differences between USPAP and say the AICPA or NACVA/IBA standards (ASA appraisers must adhere to USPAP already) and each set has its pluses and minuses, **USPAP represents an equally viable and somewhat independent source of business valuation standards**. In addition, USPAP is specifically mentioned by the IRS as an example of "professional standards" which are linked to a "qualified appraisal".

USPAP is the **only set of professional standards which incorporate BOTH real property and personal property (business interests) appraisals**. The advantages of universal business valuation standards would be wide-ranging and to the benefit of the entire SBA community. After years of contemplation and research, I have determined that **federal law (section 564.4 of Title 12) mandates the use of USPAP** for any "federally related transaction".

> **§ 564.4 Minimum appraisal standards.**
> **For federally related transactions, all appraisals shall, at a minimum:**
>
> **(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards;**
>
> **(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;**

USPAP relevance for **SBA change of ownership loans** appears to come down to interpretations of whether the 7(a) loans are "federally related transactions" and a "real estate related financial transactions". There are creative arguments "pro and con" with a bias towards mandatory compliance in my opinion. As per the CFR (section 225.62, Title 12):

> **(f) <u>Federally related transaction</u> means any real estate-related financial transaction entered into on or after August 9, 1990, that:**
> **(1) The Board or any regulated institution engages in or contracts for; and**
> **(2) Requires the services of an appraiser.**
>
> **(h) <u>Real estate or real property</u> means an identified parcel or tract of land, with improvements, and includes easements, rights of way, undivided or future interests, or similar rights in a tract of land, but does not include mineral rights, timber rights, growing crops, water rights, or similar interests severable from the land when the transaction does not involve the associated parcel or tract of land.**
>
> **(i) <u>Real estate-related financial transaction</u> means any transaction involving:**
> **(1) The sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; or**
> **(2) The refinancing of real property or interests in real property; or**

(3) The use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

Others argue that **any loan whereby the federal government has a "vested interest"** is a federal transaction**. Banking Circular 225** (1991) defined a Federally Related Transaction as **"Any transaction by any federally regulated institution, requiring the services of an appraiser."** The reality is that very few business appraisers have diligently investigated the CFR vis-à-vis the evolving SOP 50-10 series, somewhat blindly "assuming" that one approach or another is correct or acceptable. Interestingly, the ***real estate appraisal section of the SOP does in fact stipulate USPAP compliance.***

Going Concern Appraisals and the Qualified Source Attribute

A more current source of confusion revolves around the unique area of "going concern appraisals" for "special use properties". The typical SBA loan involving a business and real estate will require two different loan types (504 and 7a) and **require both a business valuation and real estate appraisal.** While all transfers of businesses require a valuation; those over \$250,000 require formal 3rd party business valuations with loans under \$250,000 subject to internally-prepared valuation analysis.

The **PRIOR SOP (Version E)** allowed real estate appraisers to perform going concern appraisals provided that they had taken a special course offered by the Appraisal Institute. A real estate appraiser **WITHOUT** one of the qualified business valuation designations (ASA, CBA, ABV, CVA and AVA) **COULD** perform a going concern appraisal if he or she

> ***"…has successfully completed the Appraisal Institute course "Fundamentals of Separating Real and Personal Property from Intangible Business Assets";***
> **and**
> ***(3) The appraisal allocates separate values to the individual components of the transaction including land, building, equipment and intangible assets.***

The **NEW SOP (Version F)** has eliminated this last option and **effectively requires a "certified" or "qualified" business appraiser** to perform all going concern or special use properties when there is at least \$250,000 in goodwill value and a business loan is being made. The top of page 175 reads as follows:

> ***e)The lender may use a going concern appraisal to meet these requirements if:***
> ***1.The loan proceeds will be used to purchase a special use property;***
> ***2.The appraisal is performed by an appraiser experienced in the particular industry and who is a "qualified source" as identified in paragraph 5.c) above and***
> ***3.The appraisal allocates separate values to the individual components of the transaction including land, building, equipment and intangible assets.***

Prior to the recent change from SOP 50-10 E to SOP 50-10 F, apparently in the case of service stations, both the real estate and business value could be appraised under a single "going concern appraisal". It is often the case that the business or intangible value for these special use properties is less than $250,000, theoretically precluding the business valuation requirement.

The SBA requires the breakdown of a going concern appraisal to include allocations to land, real estate, equipment and intangible asset value. From the lender's perspective, a ***primary emphasis is on proper allocation and the identification of the real estate value.*** In the case of Wells Fargo, Bank of America, California Bank and Trust and other banks recently surveyed by an active SBA specialist – most lenders indicate an interest in (strongly prefer) only lending on real estate and **not** on any other elements such as intangible or blue sky value (particularly in the case of gas/service stations).

A large number of banks have experienced high historical losses by erroneously lending on the going concern value and not against the real estate only value. Although there are **many going concern-based properties, the new SOP does not specifically identify any of them.** Common examples include:

1) **Assisted living and nursing homes**
2) **Car washes**
3) **Cemeteries**
4) **Daycare facilities**
5) **Golf courses**
6) **Grocery stores**
7) **Hospitality businesses such as hotels, motels, inns, etc.,**
8) **Lube facilities**
9) **Nurseries**
10) **Parking lot services**
11) **Restaurants (in some cases).**
12) **RV parks**
13) **Sand and gravel mining operation**
14) **Service stations and c-stores**
15) **Self-storage facilities**
16) **Water companies**

One problem therefore is the fact that it is simply **unclear which types of going concern properties fall under this new requirement (not to mention what the actual report content requirements are and who may be qualified to review this type of work, etc.)**. One lender was informed by a chief appraiser of a small bank in southern California that he was <u>**instructed that hotels would not be included in the going concern category.**</u> Thus, lenders appear to be receiving **contradictory and unclear direction on the properties from SBA sources.** ***Some smaller lenders are opting to avoid all special use properties altogether due to this uncertainty.***

Recognizing that a going concern appraisal is a real estate analysis and not a business valuation as such, the recent change in the SOP nonetheless removed MAIs (Members of the Appraisal Institute) and other real estate appraisal professionals as a qualified source for doing going concern appraisals and implies that **only business valuators are qualified or an MAI must pair up with a "qualified business valuator"** to complete a going concern appraisal. Many believe that there is a lack of clarity regarding this requirement, calling for changes to the SOP as soon as possible.

Using the going concern valuation of a service station as an example the real estate appraiser (who specializes in this type of going concern) may have collected hundreds of data sets and captured the details of sales which include the acquisition of the going concern. Some sales are by the owner-operators and include only the real estate component. The skilled appraiser sorts out these transactions by type. In short, **trained real estate specialists may have superior market data which includes both the real estate and other intangibles acquired.** Personal property is typically handled separately in these transactions as well as inventory, tools, etc. Once the analysis is complete, the real estate appraiser allocates value to land, real estate, depreciated fixtures and then finally intangible value. The emphasis is on isolating the real estate component of value. ***The intangible value or blue sky is what remains "at the end".***

A **business valuation does not normally have detailed real estate transaction information**, but examines the income characteristics, risk and approaches the valuation from the income stream and not the real estate. In many cases, the business valuator will factor in a market level rent as a means of excluding the real estate value (treated as non-operating revenues/expenses and assets/liabilities) from the business analysis. Business valuation comparable sales data often do not include real estate values and it is therefore **very difficult if not impossible for someone who strictly engages in business valuations to perform a true going concern appraisal inclusive of real estate value.**

Some banks are trying to pair up real estate and business valuators under the cover of a single report. This is somewhat of an unnatural pairing and business valuators will think twice before signing a report and assuming liability for the work of a real estate appraiser which goes far above their business valuation exposure (which in turn is likely to be a relatively small portion of the total value).

The Appraisal Institute, the American Society of Farm Managers and Rural Appraisers and the American Bankers Association recognized quickly that this change **effectively excludes real property appraisers from performing going concern appraisals** (without a BV credential) and have complained to the SBA that:

> **"The new policy will increase costs on consumers and lenders, delay the processing of loans and complicate bank reconciliation processes, as bank appraisal and underwriting departments attempt to reconcile and interpret two incomparable reports."**

On the other hand, the **American Society of Appraisers** appears to be **trying to work the change in their favor** by claiming that an ASA (Accredited Senior Appraiser) with a real estate specialization can in fact perform the going concern appraisals based on the SOP reference to the ASA (American Society of Appraisers) as a qualified source of credentialing. The problem that I have with this is that the **list of qualified source credentials in the "business valuation" section included only those ASA's with a business valuation specialty – not real estate (or fixed assets, etc.).**

At the same time, the Commercial Real Estate appraisal requirements found on **page 290** (Subpart C) for **Section 504 loans** reads as follows:

> ***7.If the appraisal engagement letter asks the appraiser for a business enterprise or going concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business (including intangible assets). When the collateral is a special purpose property, the appraiser must be experienced in the particular industry.***

What this appears to suggest is that if there is a real estate loan ONLY (504 program), the real estate appraiser may perform the going concern appraisal that includes a reference to going concern value or business enterprise value.

What Is or Should Be a "Qualified Source"?

There are **other issues percolating with regards to the "qualified source" criteria in the SOP.** A brand new credential known as the "Business Certified Appraiser" (BCA) has been recently created by the International Society of Business Analysts (ISBA), which is the sister organization of the NEBB Institute that offers the equipment appraisal designation Certified Machinery and Equipment Appraiser (CMEA). Led by longtime Institute of Business Appraisers Executive Director Mr. Howard Lewis, the new BCA program has been designed to focus squarely on providing real and ongoing support to the would-be business appraiser by providing practical education, support of an active network, assigned mentors and an innovative "tool chest" exclusively for its members.

If it is the case that the BCA credential is based on equal or greater standards and qualifications than the other designations, why would BCA's not be allowed as a "qualified source"? Mr. Lewis was actively involved with the IRS when it was investigating the qualified appraiser and qualified appraisal issue and they went to great lengths to avoid identifying any particular credential for fear of appearing biased or preferential in its treatment of service providers. After long and careful analysis, the IRS opted for an experience and capabilities-driven definition for a "qualified appraiser" and thereby avoided the current set of challenges facing the SBA.

> **A "qualified appraiser" is an individual who has earned an appraisal designation from a recognized professional appraiser organization, if the designation is awarded on the basis of demonstrated competency in valuing the type of property for which the appraisal is performed, or has otherwise met minimum education and experience requirements set forth by the Secretary.**
>
> **For property other than real property, the appraiser will be treated as having met minimum education and experience requirements, for returns filed after February 16, 2007, if she has (A) successfully completed college or professional-level coursework that is relevant to the property being valued, (B) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (C) fully described in the appraisal the appraiser's**

education and experience that qualify the appraiser to value the type of property being valued.

An additional requirement to being a qualified appraiser is that the individual regularly performs appraisals for which she receives compensation. Furthermore, the individual will not be treated as qualified if she has been prohibited from practicing before the IRS at any time during the three year period ending on the date of the appraisal. The determination of whether an appraiser is qualified must be based on the appraiser's qualifications as of the date the appraisal is made.

Concluding Thoughts and a Call for Action

Having been **involved with SBA business valuations for nearly 20 years now** (as a business broker and business appraiser, including my new role as Chair of the SBA Valuation Issues Committee of the ISBA), I have witnessed an **increasingly active and proactive SBA in the realm of 7(a) and 504 loans** generally and specifically with respect to business valuation requirements. ***Despite the real progress unfolding since 2008, there is still much room for improvement across the valuation and appraisal spectrum.***

I am routinely contacted by business appraisers and lenders with an array of questions involving the "what, why, when, how and who" of these ever-changing business valuation requirements. **Besides the question of "who" can perform these engagements, there is a great deal of uncertainty as to "how" to prepare the reports and how to determine "what" type of reports are acceptable**. A few sample questions are:

1. **Is a summary or limited or "calculation report/calculation value" acceptable for SBA loan purposes and what is the minimum acceptable scope of work?**
2. **Are the USPAP requirements applicable to business appraisers or only real property appraisers?**
3. **Can or must the synergistic benefits associated with the known buyer be incorporated into the valuation analysis as it relates to the ability to repay the debt?, i.e. can or should investment value be used in lieu of fair market value?**
4. **Is a separate valuation of equipment needed beyond the business valuation and real property appraisal?**
5. **Is a site visit mandatory or optional?**
6. **What is the appropriate or required valuation effective date?**
7. **Is there any type of formal review process used by SBA personnel?**

With the **current uncertainty revolving around the "qualified source" requirements** (in general and specifically with respect to going concern appraisals) possibly preventing loans from taking place, it would be beneficial for **all stakeholders to have an opportunity to meet jointly with SBA personnel** to discuss, debate and help refine the current SOP 50-10 (5) F appraisal policy. In light of the recent administrative changes at the highest levels of the SBA and their proven willingness to work closely with stakeholders, this may be an opportune time for a **"Valuation Summit"** with representatives from each of the primary disciplines (real estate, business and equipment) and each of their respective professional organizations meeting to discuss a predetermined set of core issues currently in need of attention.

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Appendix

The following compares the prior and current SOP verbiage with respect to appraiser requirements:

SOP 50-10 F (current version – page 174)

c) A "qualified source" is an individual who regularly receives compensation for business valuations and is accredited by one of the following recognized organizations:

1. Accredited Senior Appraiser (ASA) accredited through the American Society of Appraisers;
2. Certified Business Appraiser (CBA) accredited through the Institute of Business Appraisers;
3. Accredited in Business Valuation (ABV) accredited through the American Institute of Certified Public Accountants;
4. Certified Valuation Analyst (CVA) accredited through the National Association of Certified Valuation Analysts; and
5. Accredited Valuation Analyst (AVA) accredited through the National Association of Certified Valuation Analysts.

e) The lender may use a going concern appraisal to meet these requirements if:

(1) The loan proceeds will be used to purchase a special use property;

(2) The appraisal is performed by an appraiser experienced in the particular industry and who is either a "qualified source" as identified in paragraph 5.c) above or has successfully completed the Appraisal Institute course "Fundamentals of Separating Real and Personal Property from Intangible Business Assets"; and

(3) The appraisal allocates separate values to the individual components of the transaction including land, building, equipment and intangible assets.

SOP 50-10 E (prior version – page 194)

c) A "qualified source" is an individual who regularly receives compensation for business valuations and is either:

(1) A licensed Certified Public Accountant (CPA) that performs the business valuation in accordance with the "Statement on Standards for Valuation Services" published by the American Institute of Certified Public Accountants (AICPA); or

(2) Accredited by one of the following recognized organizations:

(a) Accredited Senior Appraiser (ASA) accredited through the American Society of Appraisers;

(b) Certified Business Appraiser (CBA) accredited through the Institute of Business Appraisers;

(c) Accredited in Business Valuation (ABV) accredited through the American Institute of Certified Public Accountants;

(d) Certified Valuation Analyst (CVA) accredited through the National Association of Certified Valuation Analysts; and

(e) Accredited Valuation Analyst (AVA) accredited through the National Association of Certified Valuation Analysts.

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e) The lender may use a going concern appraisal to meet these requirements if:

(1) The loan proceeds will be used to purchase a special use property;

(2) The appraisal is performed by an appraiser experienced in the particular industry and who is either a "qualified source" as identified in paragraph 5.c) above or has successfully completed the Appraisal Institute course "Fundamentals of Separating Real and Personal Property from Intangible Business Assets"; and

(3) The appraisal allocates separate values to the individual components of the transaction including land, building, equipment and intangible assets.