



# Improving the Appraisal Function in Resources Land Acquisitions

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Land acquisitions by state resource agencies are a widely used tool for resource conservation. Although appraisals can play a key role in determining the purchase price and ensuring that taxpayers are not overcharged, the quality and objectivity of state resource-related appraisals are impeded by a lack of comprehensive standards and insufficient independence of the appraisal function. Limits on the public disclosure of appraisal-related information make public and legislative oversight of resource acquisitions difficult. In this report, we make several recommendations to establish a sound process to guide the appraisal function for resource acquisitions. ■

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## EXECUTIVE SUMMARY

Over the years, the state has spent billions of dollars in public funds to acquire land for resource conservation and currently substantial amounts of new bond funds are available for the same purpose. However, the state lacks a process to facilitate good quality appraisals to support the purchase price of these acquisitions. The absence of a sound process is problematic as there are a number of factors that often make determining the value of property in resource acquisitions particularly challenging. These factors include limited or nonexistent comparable sale properties and technically complex issues in determining a property's development potential (relevant to assessing a property's market value).

The absence of a sound appraisal process manifests itself in a number of ways. Our review, for example, found that appraisal-related practices vary significantly among the state's resource agencies, reflecting the lack of a consistent, comprehensive set of standards to guide them. We also found that the appraisal function is often too closely linked to the acquisition process of the land-acquiring agency—a party that has a strong interest in the outcome of the acquisition. This brings into question the objectivity of the appraisal process. Finally, the general lack of appraisal-related information that is made public

before resource acquisitions are completed limits opportunities for public or legislative oversight of these acquisitions.

Without a sound process in place to guide the appraisal function for these acquisitions, the state may be paying too much for the resources properties that it is acquiring. We have a number of recommendations to establish such a process. First, we recommend the enactment of legislation requiring the development of a specified set of appraisal standards for resource conservation acquisitions. These standards should serve as the basis for state-funded resource acquisitions, regardless of the type of acquisition (grant or direct purchase), or the resource agency funding the acquisition. Second, to improve the independence of the appraisal process, we recommend that the appraisal function for these acquisitions be focused in the Department of General Services. Next, we recommend that existing requirements to publicly disclose appraisal-related information be expanded, and that improvements be made to the legislative notification process for these acquisitions. Finally, we recommend that steps be taken to avoid unwarranted tax benefits in connection with these acquisitions, by improving the flow of information between the state's resource agencies and its tax agencies.

## INTRODUCTION

### ***The Importance of the Appraisal Function.***

Land acquisitions by state resource agencies are a widely used tool for resource conservation. Since 2000, the state has spent over \$2 billion mostly from various resources bonds to acquire land for resource conservation purposes. In addition, a resources bond approved by the voters in November 2006 provides upwards of \$1 billion potentially allocated for new land acquisitions. Appraisals play a key role in the process for determining the value of the land and its purchase price. The state relies on appraisals to ensure

“In spite of the key role potentially played by appraisals, questions have been raised about the state’s resources-related appraisal process.”

that taxpayers are not overcharged.

When carried out well, the appraisal function provides public agency decision-makers with reliable, necessary information to assist them in making fiscally prudent decisions. With a sound process in place to guide the appraisal function, the Legislature and

taxpayers are better assured that they are protected from potential abuses of the function, which if left unchecked might lead to the state paying too much for a property.

***Concerns With the Current Appraisal Process.*** In spite of the key role potentially played by appraisals, questions have been raised about the state’s resources-related appraisal process. Spe-

cifically, there are concerns that the appraisals for these transactions may be conducted in ways that bring into question their objectivity and thus their credibility. This is because they may not be conducted sufficiently independent of parties (including sellers, but also the public agency purchaser) that have a direct interest in the land transaction.

Our review found that the state lacks a systematic approach to carrying out the appraisal function for resources-related acquisitions, with practices varying among state resources agencies. For example, lacking a consistent set of standards to guide them, state resource agencies vary in the extent to which the appraisal function is conducted independently from parties (including themselves) who have a strong interest in the outcome of the acquisition. Also, there is inconsistency regarding the amount of appraisal-related information that is disclosed to the public (and thus to taxpayers) prior to a publicly funded land acquisition transaction being finalized. In fact, for many transactions, little or no information about the appraisals is disclosed publicly prior to the deal.

***The Focus of This Report.*** State agencies fund land acquisitions for various purposes other than resource conservation (such as to develop a state office building or in connection with highway construction). However, this report focuses on the appraisal process for resources-related acquisitions for two reasons. First, the state either has spent or is poised to spend in the future a substantial amount of funds on this type of land acquisition. Second, concerns have been raised, notably at the federal level, about appraisal-re-

lated problems with publicly funded acquisitions for resource conservation purposes.

In this report, we define land acquisitions as cases where state funds are used to acquire title as well as partial interests in property, such as conservation easements, from a *willing* seller. Accordingly, the report does not consider situations where the state acquires property through the power of eminent domain.

In the first section of this report, we provide a brief introduction to the appraisal process and discuss some of the unique features of acquisitions for conservation purposes. In the next section of the report, we discuss the problems in the current state appraisal process. Lastly, we make recommendations on how to improve the appraisal process, in part based on recent federal findings regarding effective appraisal practices in resource transactions.

## BACKGROUND

### Resources Land Acquisitions

Since 2000, the state has spent over \$2 billion for resources land acquisitions, including both fee title acquisitions and purchases of conservation easements. These lands and easements have been acquired for various purposes, including for expansion of the state park system, restoration of fish and wildlife habitat, preservation of open space, provision of public access to the coast, and creation of flood protection corridors. (Easements are a relatively common type of property acquisition for some resource agencies. For example, they have been frequently acquired by SCC for public access purposes, and by WCB for habitat protection purposes.) These

**Methodology.** In reviewing the appraisal process, we interviewed the staff of various resources departments responsible for funding land acquisitions including the Wildlife Conservation Board (WCB), State Coastal Conservancy (SCC), Department of Parks and Recreation (DPR), the Secretary for Resources, the Department of Conservation (DOC), and the Tahoe Conservancy. We also interviewed staff of the Department of General Services (DGS), the Office of Real Estate Appraisers, the Franchise Tax Board (FTB), the Internal Revenue Service (IRS), and the United States Department of the Interior (USDOI). Finally, we also interviewed representatives of several land trusts in California (nonprofit organizations which acquire land); a professional association of land trusts; and the Appraisal Institute, an international membership association of professional real estate appraisers.

acquisitions have been made throughout the state, and have been made directly, or funded through grants, by various state agencies. These agencies include the state's nine land conservancies, DOC, DPR, WCB, the Department of Fish and Game (DFG), and the Department of Water Resources (DWR).

Figure 1 (see next page) shows some of the largest state-funded resources land acquisitions (in terms of purchase price) over the last five years. A key element of the purchase of these resources lands, as with the purchase of any real property, is an appraisal to determine the value of the property. The focus of this report is on this appraisal process.

**Appraisals Play a Key Role in Resources Land Acquisitions**

***Current Law Requirements for Appraisals.***

Under current law, the role of appraisals is much more defined in cases where a public agency is acquiring property under its powers of eminent domain than in cases of acquisitions from willing sellers. In the case of eminent domain, statute requires an appraisal of the property’s fair market value (FMV) as part of the condemnation proceedings. This appraisal assists in determining the just compensation legally owed to the property owner, such compensation generally being no more and no less than the property’s FMV.

In contrast, there is no statutory provision applicable to all state entities requiring appraisals when the state is acquiring or funding an acquisition of property in general or resources property in particular from a willing seller. Similarly, there are no statutory requirements of general application specifying what the state must pay or is authorized to pay when acquiring property from a willing seller. (As discussed below, there are *department-specific* statutory requirements on both of these issues.)

As regards the latter issue of what to pay,

state acquisition agencies as a matter of practice have generally interpreted the provision in the State Constitution prohibiting a gift of public funds as preventing them from paying *more* than a property’s FMV. This interpretation of the Constitution is consistent with longstanding legal opinions of the State Attorney General’s Office and Legal Counsel at DGS. At the very minimum, purchasing property with public funds at an amount greater than the property’s FMV raises a red flag as to whether this constitutional provision has been violated, even if it were argued that the constitution does not explicitly ban

**Figure 1**

**Large State-Funded Resources Land Acquisitions**

*Since 2002*

- ✓ **Ahmanson Ranch (Ventura County)**—a \$150 million acquisition of over 2,900 acres by the Santa Monica Mountains Conservancy (SMMC), for purposes of wildlife habitat conservation and public recreation. The acquisition was funded by the Wildlife Conservation Board (WCB), the State Coastal Conservancy (SCC), and SMMC.
- ✓ **Ballona Wetlands (Los Angeles County)**—a \$140 million acquisition of 193 acres by WCB, for purposes of wildlife habitat conservation. The acquisition was funded by WCB and SCC.
- ✓ **Hearst Ranch (San Luis Obispo County)**—a \$92 million acquisition of over 1,500 acres in fee title (acquired by the Department of Parks and Recreation [DPR]) and 80,000 acres under easement, for purposes of conservation of wildlife habitat, farmland, and public recreation along the coast. The acquisition was funded by SCC, WCB, and the California Department of Transportation (Caltrans).
- ✓ **Bolsa Chica Ecological Reserve (Orange County)**—a \$65 million acquisition of 103 acres of vacant land to expand the Department of Fish and Game’s Bolsa Chica Ecological Reserve, for purposes of open space preservation and plant and wildlife habitat. The acquisition was funded by WCB.
- ✓ **Mendocino Headlands State Park, Big River Unit (Mendocino County)**—a \$30 million acquisition of over 7,300 acres by DPR, for purposes of creating a wildlife corridor and providing public recreational opportunities. The acquisition was funded by DPR, WCB, SCC, Caltrans, and a number of federal and nonprofit entities.

such transactions. It is important to note that this constitutional provision has been interpreted as imposing a cap on the purchase price, in contrast to dictating a minimum amount to be paid to a willing seller. Accordingly, the state can and does sometimes pay less than FMV for property, potentially triggering a tax benefit for the seller, as discussed later in this report.

Even though general requirements are lacking, legislation has established a number of department-specific requirements for appraisals and limits on a property's purchase price when the state or a grantee of state funds is acquiring property from a willing seller. Where the Legislature has set limits on the purchase price, the upper bound on the purchase price has consistently been set at FMV. As an example of these requirements, Chapter 309, Statutes of 1997 (SB 156, Johannessen), requires WCB, when acquiring property in cases other than eminent domain, to obtain a FMV appraisal for the property and to pay no more than the FMV for the property. Similarly, legislation establishing the state's several land conservancies, such as the Tahoe Conservancy, typically requires that nonprofit organizations acquiring property using a grant from the conservancy must pay no more than the property's FMV as established by a conservancy-approved appraisal. As another example, Chapter 344, Statutes of 1998 (AB 2394, Margett), requires DPR to conduct an appraisal, and have this appraisal reviewed and approved by DGS (or a DGS-approved reviewer), prior to commencing negotiations to purchase property.

***Appraisals Are Widely Used in Practice.***

Even though, as a general rule, statute does not explicitly require an appraisal or limit the purchase price that can be paid for a resources-related property acquisition, we found that appraisals

are widely used in state-funded resource acquisition programs in practice. We found appraisals are used either (1) to determine the price that the state will offer to a willing seller or (2) to support a purchase price after it has been negotiated. As an example of the first case, DPR, as required by statute, completes an appraisal of lands being acquired for a state park in order to determine a price to offer to a seller. As an example of the second case, the grant guidelines for the Resources Agency's River Parkways Program require that an applicant submit an appraisal supporting the negotiated price.

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***Appraisals for Resources Land Acquisitions: Market Value or Public Interest Value?***

When appraising the value of resources lands for acquisition, there has been much discussion as to whether to use market value or public interest value (PIV). Market value appraisals attempt to assess a property's value based on its highest and best *economic* uses (for example, uses that would produce income). But the acquisition of resources lands may be for purposes such as conservation which cannot or are not easily measured

in terms of their economic uses. In such cases, some have argued that the appraisal should be based on PIV which attempts to place a value on the *noneconomic* uses of the property (in other words, uses that do not produce income). For example, this could include the value of the land as wildlife habitat or as open space. Some proponents of PIV view it as a “premium” value in addition to market value, while others have considered it to be a component of market value.

Suffice it to say, the role of PIV in government resources land transactions is a subject of controversy and some confusion. Nevertheless, when current state law explicitly addresses the issue of the purchase price in such state-funded transactions, it caps it at FMV. Accordingly, for purposes of this report, we adopt the consensus view of the professional appraisal community, as well as of California state resources land acquisition agencies, that FMV is the proper basis for estimating the value of resources lands for government acquisitions. While PIV may not play a role in the appraisal process when determining value of a property, there is a potential role for it to play in the public decision making process that determines which properties to purchase in the first place. Clearly, setting priorities among potential acquisitions based on the degree to which each would advance a public agency’s statutory mission involves applying public interest values.

**Appraisal Terminology.** Please see the box on page 10 for definitions of commonly used appraisal-related terminology that we reference throughout this report.

### **Current Appraisal Process**

The appraisal process for resource acquisitions involves three main steps: (1) commission-

ing the appraisal, (2) conducting the appraisal, and (3) the appraisal review. Below, we briefly describe the current appraisal activities of the resource departments we reviewed.

**Commissioning an Appraisal.** In most cases, resource departments acquiring property or funding acquisitions through grants do not conduct their own appraisals. This is largely because the departments do not have the staff or technical expertise to do so. Departments can obtain appraisals in a variety of ways, including (1) using the appraisal commissioned by another party, such as the seller, the grantee applying for state grant funds to acquire the land, or a land trust acting as an intermediary; (2) having the seller or a land trust pay for an appraisal to be commissioned by the department; or (3) paying for the appraisal themselves to be done by a contractor or in a relatively few cases by DGS.

**Conducting an Appraisal.** The role of the appraiser, once hired, is to provide an objective and unbiased opinion about the value of the subject property. Professional appraisal standards provide guidance as to the major considerations in determining this value. These considerations include analyzing recent sales of comparable properties (as close as possible to the subject property) and the value indicated by the property’s ability to produce income. (If a property has structures on it, the appraiser would also consider the current cost of reproducing or replacing these structures as part of the valuation exercise.) Most appraisals are reported in writing. The written appraisal report generally includes a description of the property and its location, an analysis of the property’s highest and best use and of sales of comparable properties, and information about current real estate activity and market trends in the subject area.



**Appraisal Review.** The appraisal review requirements for resource departments vary based on whether the appraisal was for a direct acquisition by a state agency or whether the state provides funding through a grant to a third party, such as a local government or nonprofit organization, to acquire the land.

- **Direct Acquisitions by the State.** For direct acquisitions of real property by most state agencies, statute provides an approval role for both DGS and the State Public Works Board (PWB). First, with few exceptions, every contract for the acquisition of real property entered into by or on behalf of the state must be approved by the Director of General Services. Practically speaking, this approval role involves DGS reviewing and approving the appraisal as part of its exercise of due diligence, although statute does not explicitly require this. Second, as a general rule, real property acquisitions made directly by state agencies must also be approved by PWB (which is staffed by DGS for this purpose), unless the acquiring agency is exempt from the PWB process. (Resource agencies exempt from the PWB process are WCB, DFG, DWR, and the State Reclamation Board; in addition, certain categories of property acquisitions of the State Lands Commission and SCC are also exempt.) Before such acquisitions are approved by PWB, the appraisals are reviewed and approved by DGS, again as a matter of practice, rather than because of an explicit statutory requirement. For land acquiring agencies outside of the PWB process, statute sometimes explicitly requires DGS

to review and approve an appraisal, such as in the case of acquisitions made by WCB. In cases where DGS is charged with reviewing an appraisal, it is generally the land-acquiring department that selects the appraisal to be reviewed by DGS.

- **Grant-Funded Acquisitions.** Review of appraisals for acquisitions funded by grants varies across state granting agencies. As a general rule, current law does not require a DGS appraisal review for acquisitions funded by state grant funds. Although not required, we found some departments do forward such appraisals to DGS for review. For example, the Office of the Secretary for Resources and WCB both require that all grant applications include appraisals to be reviewed by DGS. However, other departments will either rely on administrative staff to do most of the appraisal reviews or, in the case of DPR, not review appraisals as part of their local assistance process.

### **Appraisal-Related Staffing**

As noted above, we found most resource departments do not have specific staff dedicated solely to conducting appraisals or reviewing appraisals done by others. (The DWR has a few staff spending some of their time working on appraisal matters for small acquisition transactions in the flood-related context.) When departments do not use appraisals from land trusts, grantees, or sellers, appraisals are generally contracted out. Once appraisals are completed, any reviews typically are done by DGS or the resource departments, and in a few cases the reviews are contracted out. The management of contracts for both appraisals and any review of appraisals are

## GLOSSARY OF TERMS

**Appraisal.** The act or process of developing and communicating an estimate of the value of property. In the appraisal industry, the standard terminology (which we adopt in this report) is to refer to an appraisal as a professional appraiser’s “opinion of value” of property. Generally, professional appraisers are charged with conducting *market value* appraisals, which involves the estimation of a property’s fair market value (FMV). (See below for a definition of FMV.)

**The Appraisal Foundation.** In 1987, The Appraisal Foundation (TAF) was established to implement the Uniform Standards of Professional Appraisal Practice (USPAP)—the generally accepted statement of professional appraisal principles. (The USPAP are discussed in more detail at the end of the glossary.) In 1989, Congress enacted Title XI of the Financial Institutions Reform Recovery and Enforcement Act. As a result of the legislation, TAF is responsible for establishing the qualification criteria for state licensing and certification of appraisers, and for setting forth the rules for developing an appraisal and reporting its results. The TAF is a non-profit organization partially funded by a federal grant.

**Appraisal Institute.** An international membership organization of over 21,000 professional real estate appraisers and members in related fields; involved in appraisal-related education, research, and promotion of professional practice standards.

**Appraisal Report.** A written report stating an appraiser’s official opinion of the value of property as prepared under the rules of USPAP. Appraisal reports can vary significantly in the content and level of information provided.

**Appraisal Review.** Appraisal reports can be reviewed in two general ways:

- **Technical Appraisal Review.** A technical appraisal review is performed by an appraiser and involves developing and communicating an opinion using USPAP about the quality of another appraiser’s work. As part of a technical review, the reviewer may approve, disapprove, or modify the other appraiser’s conclusions. If the reviewer determines a new value for the property, that value may serve as the appraisal. There are two different levels of technical reviews: (1) a desk review, which is limited to the information contained in the appraisal report, and (2) a field review, which represents a more comprehensive level of review and includes inspection of the property and may also include confirmation of market data used in appraisals.
- **Administrative Review.** For purposes of this report, an administrative review is a review of an appraisal by a nonappraiser, such as a land agent at the state agency funding the acquisition. Administrative reviews are not subject to USPAP. The administrative reviewer does not form an opinion of value of the property, but instead generally merely confirms that the appraisal meets the contractual obligations under which the appraisal was performed.

often done by the same staff managing the land acquisition or reviewing the grant application.

At DGS, there are currently two full-time ap-

praisers (conducting appraisals) and two full-time appraisal reviewers for all (resource and non-resource) state property acquisitions. (Functionally,

### **Glossary of Terms (continued)**

**Conservation Easement.** A conservation easement is typically held by a private nonprofit or government agency and generally imposes permanent restrictions on the property in order to protect its resources-related values, such as agriculture and wildlife. These restrictions may include limits on allowable development.

**FMV.** Definitions of FMV typically include the following elements: the probable price for which a specified property would sell after a reasonable exposure on the competitive market, with the buyer and seller acting knowledgeably, in self-interest, and without undue pressure.

**Highest and Best Use.** In developing an opinion of a property's market value, an appraiser must determine the value based on a realistic assessment of the use of the property that results in the highest economic value.

**Property Acquisition Law.** This state law outlines the process for the acquisition of real property by or on behalf of state agencies, and establishes a role for the State Public Works Board (see below). The law also addresses other issues, including the jurisdiction over real property once it is acquired.

**State Public Works Board (PWB).** The PWB acquires or approves the acquisition of land and other real property on behalf of most state agencies, among other duties related to the state's capital outlay process. Some resource departments are exempted from the PWB process, including, among others, the Wildlife Conservation Board, the Department of Fish and Game, and the Department of Water Resources. The PWB's voting members include the Director of Finance, Director of Transportation, and Director of General Services; and the State Controller and State Treasurer for revenue bond matters only. Staff support to PWB is provided by the Department of General Services (DGS) for real property acquisitions and sales and by the Department of Finance's capital outlay unit for all other matters. As staff to PWB on real property acquisition matters, DGS obtains the information needed to assure PWB that the price offered for the property is fully supported by an appraisal.

**USPAP.** The USPAP are the generally accepted statement of professional appraisal principles recognized throughout the United States. The USPAP are quite broad and are not intended to provide specific direction on how to conduct appraisals. For example, USPAP require appraisals to be set forth in a way that is not misleading and contain sufficient information to enable the intended users of the appraisal to understand the report.

The USPAP are considered minimal standards and allow for the use of supplemental standards in addition to USPAP when appraising property. The USPAP standards are developed by TAF.

the appraisers work separately from the appraisal reviewers.) While roughly one-half of the workload of the two appraisers typically relates to resource transactions, the vast majority of the workload of the reviewers pertains to resource transactions. Accordingly, the total number of appraisals reviewed by DGS varies largely depending upon the number of resource acquisitions funded in a given year. Between 2000-01 and 2004-05, the annual total number of appraisals reviewed by DGS (all types of acquisitions) ranged from 152 to 225, with resource acquisitions representing about 85 percent of these appraisals.

### **Resource Acquisitions Can Be Challenging**

There are several features of resource acquisitions that can present unique valuation challenges. The following are some of the factors that make the valuation of property in natural resource acquisitions particularly challenging.

***Resource Acquisitions May Have Few Comparables.*** One of the primary methods of determining FMV in an appraisal is by analyzing the recent sales of comparable property. The Uniform Standards of Professional Appraisal Practice (USPAP) specify that appraisers are to use the most relevant comparable sales in their analysis. Often times, for conservation transactions, the number of relevant comparable sales is limited or nonexistent. This may be because the property being acquired is in a relatively isolated area with limited sales transactions. This may also reflect the relative uniqueness of the acquisition property in terms of factors such as its highest and best use. For example, conservation transactions may involve land that is currently undeveloped or minimally developed, complicating the “highest and best use” determination and making it difficult to find comparables. In situations where

there are a limited number of comparable sales, appraisers need to search further for relevant comparables and analyze the similarities and differences between the comparables and the subject property.

***Determining Development Potential Can Be Challenging.*** As part of the appraisal process for both resource and nonresource transactions, the appraiser evaluates the development potential of the subject property in determining its highest and best economic use, and thus its market value. Such development potential is often difficult to determine because development typically would be contingent on the resolution of land use and environmental permitting issues—processes that can be rife with uncertainty. While such permitting issues are not unique to resource transactions, the inherent resource values in lands being considered for a conservation transaction tend to magnify the complexity of these issues, adding to the uncertainty of assessing a property’s development potential.

***Resource Agencies May Be Under Undue Pressure to Purchase Specific Properties.*** The definition of FMV—the value to be estimated in the appraisal process—assumes that neither the buyer nor seller is acting under any undue pressure to buy or sell. However, land-acquiring resource agencies can find themselves under particular pressure, not only from within the organization but also from outside interest groups and political forces, to acquire specific properties. These may be properties that have “one of a kind” resource values that are integrally related to a department’s mission. If these pressures are left unchecked, a resource agency could end up paying more than FMV for a property. This can happen, for example, if the appraisal process is not conducted sufficiently independent of the

land-acquiring resource agency, such that the estimation of FMV is unduly influenced by these pressures bearing on the agency. Accordingly, caution should be exercised when relying on other conservation transactions as comparable sales, given that these transactions may have been subject to pressures that taint the estimation of FMV. (The importance of an independent appraisal process will be discussed in detail later.)

**Valuation Challenges When Less Than Full Title Is Purchased.** Acquisitions involving the purchase of something less than full title to a particular parcel of land make up a significant portion of resources-related acquisitions. These cases mostly involve the purchase of conservation easements. For example, since 1978, WCB has purchased on behalf of DFG over 160 ease-

ments, protecting about 367,000 acres of land. Determining the FMV of conservation easements that are acquired or funded by state agencies can be complex for a few reasons. First, because the seller of the easement still owns the underlying parcel of land that is subject to the easement, valuing an easement is inherently not as straightforward as valuing an outright acquisition of a parcel of a land. Also, there are typically few, similar, easement-encumbered lands in the vicinity of the subject property. In addition, even where similar conservation easement sales exist, the fact that such sales typically involve public agency purchasers or are publicly funded limits the use of these sales as comparables to the extent that undue purchasing pressures discussed above influence the sales price.

## CURRENT APPRAISAL PROCESS HAS MANY PROBLEMS

In recent years, the federal government has had its own problems with appraisals for federally funded resource conservation acquisitions. (We discuss the findings and related reforms made at the federal level in the box on the next page.) Many of the problems that we have identified at the state level and discuss below are similar to the concerns raised at the federal level. We think that the findings and related reforms made at the federal level can provide valuable guidance to California as the state evaluates its appraisal processes for similar transactions.

**Summary of Concerns at State Level.** Our review identified a number of problems with the current appraisal process used for state-funded conservation acquisitions, which we summarize in Figure 2. First, the process lacks a comprehensive set of standards that are explicitly required to be followed by state resource agencies when

**Figure 2**

### Concerns With State’s Appraisal Process for Resource Acquisitions

- ✓ Lack of comprehensive standards, impeding quality control
- ✓ Appraisal and acquisition functions too closely linked, impeding objectivity
- ✓ Lack of publicly available information, impeding accountability

obtaining appraisals for land transactions. Also, the process does not encourage independence of the appraisal function from the acquisition function, thereby impeding objectivity of the appraisal function. Additionally, there is a lack of publicly available information on the appraisals conducted for state-funded resources-related acquisitions, thereby making legislative oversight of

the acquisition transaction difficult. As a consequence of these problems, the current appraisal process fails to facilitate oversight, quality control, and accountability, and most significantly, it does not ensure that the state is not overpaying for resource conservation acquisitions. We discuss each of these problems in the sections that follow.

### **CONCERNS RAISED AT FEDERAL LEVEL WITH RESOURCE ACQUISITION APPRAISALS**

Recently, there has been considerable attention focused at the federal level on the need to improve the appraisal process for federal land transactions for conservation purposes.

#### ***Problems Trigger Appraisal Reforms at United States Department of Interior (USDOI).***

Reports have been issued by USDOI's Office of Inspector General and the Government Accountability Office discussing problems with the appraisal process related to federal resources-related land transactions. The primary finding of these reports was a lack of an unbiased, independent appraisal process. As a result, the reports found instances in which the USDOI agencies were overpaying for public land across the West. The reports also recommended reforms to the appraisal process which have since been implemented, including establishing an independent, centralized appraisal unit in the USDOI made up of appraisers from across different departmental agencies.

***Tax-Related Concerns Raised at Federal Level.*** There have also been concerns raised at the federal level related to acquisitions for conservation purposes which involve charitable contributions resulting in a tax benefit. Charitable contributions occur when a charitable entity (such as a governmental entity or nonprofit organization) pays less than fair value market (FMV) for property. The difference between the sale price and property's higher FMV reflects the potential charitable tax deduction which the seller can take on his taxes. Concerns have been raised in news stories, public statements by the IRS, and the United States Senate Committee on Finance that excessive appraisals—that is, appraisals in excess of FMV—are sometimes being used in conservation transactions, thereby resulting in unwarranted tax deductions. (To the extent that unwarranted federal tax deductions are being taken, it would follow that unwarranted state tax deductions may also be taken. However, in any particular case, the amount of the state tax deduction that is taken in conjunction with a federal deduction would typically be smaller given higher rates of federal taxation versus state taxation.)

While these tax-related concerns relate to the *taxpayer's* use of appraisals to support a tax claim as opposed to a *public agency's* use of appraisals to support the acquisition price in a

## **NO STANDARD PRACTICES FOR KEY APPRAISAL STEPS**

### **Wide Variation in Appraisal Practices**

The process by which an appraisal is generated in a resources-related land acquisition involves many steps, including hiring an appraiser,

determining the type and level of information to be provided in the appraisal report, and reviewing the appraisal. Our review finds that there is significant variation in how these steps are approached, not only among resources agencies, but also within these agencies as well, and the justification for this variation is often not clear.

### **Concerns Raised at Federal Level With Resource Acquisition Appraisals (cont.)**

publicly funded resources land transaction (the focus of this report), these two distinct appraisal processes can purposefully overlap. For example, as will be discussed later in this report, the government's appraisal for the acquisition can serve to advise state and federal tax authorities charged with verifying an appraisal value provided by a taxpayer making a related tax claim. It is important to note that a distinction needs to be made between the cost to government (in terms of lost tax revenues) when an above-FMV property appraisal for tax purposes is left unchecked and the cost to government in making the direct outlay for the property acquisition that became the subject of the tax claim. The impact on the public purse overall depends on these two different costs. For example, the negative impact on government revenues of an unwarranted tax claim could be partially or fully mitigated by government getting a particularly "good deal" when, in a willing seller-willing buyer transaction, it acquired the property at less than FMV.

It is not known how frequently taxpayers have claimed such unwarranted tax deductions and the size of the unwarranted claims. This makes it difficult to assess the extent of this problem, including the potential fiscal impact on federal and state tax revenues. In response to evidence of a significant loss of federal tax revenues due to the claiming of unwarranted tax deductions in a number of large conservation-related transactions, the IRS has taken a couple of steps to gain better information and prevent this problem from developing further. These include increasing audits of charitable contributions involving conservation properties and issuing new, more stringent rules for claiming a tax deduction. In addition, the Senate Finance Committee has issued a report with recommendations calling for statutory changes that would reduce the amount of the charitable contribution eligible for a tax benefit in conservation easement transactions. Finally, in response to the problems identified at the federal level, national conservation organizations have also issued guidance to assist nonprofit conservation land trusts in their consideration of appraisals.

### **Variation Reflects Lack of Standards; Accountability Impeded**

This variation in appraisal practices reflects the lack of a comprehensive set of standards to guide the development, use, and review of appraisals for resources-related land acquisitions. As a consequence of the lack of standards, there is no benchmark to help assure that the state is getting good quality appraisals. It is also difficult for the Legislature to exercise oversight because there are no standards by which to hold land-acquiring agencies accountable.

**Gaps in Current Law.** While there are some requirements under current law and administrative regulations relating to the appraisal process, they do not address many components of this process. Specifically, commissioning the appraisal, the level of information in the appraisal, qualifications of the appraiser, and the level of appraisal review are generally not dealt with. In addition, these appraisal requirements do not always encompass the full universe of state-funded acquisitions. For example, while the Property Acquisition Law requires most acquisitions made directly by state agencies to be approved by PWB, thereby requiring an appraisal approved by DGS, this statutory requirement does not pertain to state grant-funded acquisitions made by local agencies or nonprofit entities.

**Gaps in Professional Standards.** We also find that current professional standards do not sufficiently address a number of issues specific to resources-related acquisitions. While licensed appraisers are subject to a set of professional standards (USPAP), these standards often do not address many of the complexities associated with the valuation of resources lands for public acquisition noted earlier. For example, when an appraiser is developing an opinion of

value for a property, he/she must identify under what scenario the land will achieve the highest value—this is referred to as highest and best use. However, often the properties considered for acquisition for resources purposes have very uncertain development potential. As a result, the determination of the highest and best use can vary greatly depending upon the assumptions that are made about the development potential of the property. The current USPAP standards generally provide little guidance on how to handle such development uncertainties.

In addition, the current USPAP guidelines do not specifically address the valuation of conservation easements or how to use previous conservation-related transactions involving government agencies or nonprofit entities as “comparable” sales when generating an appraisal. The use of such sales to public or nonprofit entities as comparables can present challenges because often the sales price in such transactions does not reflect the property’s FMV, but rather an amount lower than FMV so as to accommodate a charitable contribution.

### **Components of Appraisal Process Requiring Standards**

Below, we discuss in greater detail the specific components of the appraisal process for resources-related acquisitions for which standards are lacking, resulting in wide variation in appraisal practices.

**Commissioning the Appraisal.** Commissioning an appraisal (hiring the appraiser) is an important step in the appraisal process because it is at this point that important terms (such as the scope of the appraisal) are established. Also, who is given the responsibility for commissioning the appraisal is very relevant for establishing the independence of the appraisal process.



Currently, however, there are no state guidelines governing this. In practice, the appraisal may be commissioned by the seller, the grantee of state funds who may acquire the property, a land trust involved in the transaction, the resources department funding the land acquisition, or by DGS.

**Qualifications of the Appraiser.** Acquisitions for land conservation can often be complex and require specific expertise, including knowledge of a particular geographical area, water rights, and the value of timber. Currently, some departments specify the technical expertise requirements of the appraisers that do work on their behalf, others do not. Some departments keep a list of qualified appraisers, others do not. As a result, acquisitions are potentially assessed by appraisers who do not have the expertise and experience necessary for the particular type of acquisition at issue.

**Timing of the Appraisal.** One of the key features of a good appraisal process is ensuring that the appraisal is done before a final price is negotiated for the property, so that the appraisal can guide the price negotiations. However, we found that appraisals are sometimes done after a price has been negotiated, depending on the particular resources department involved in the transaction and whether a direct land acquisition or a grant is at issue.

**Level of Information in Appraisal Report.** We found that there are no content guidelines on the type and level of information to be included in an appraisal report. Such guidelines are particularly important when one considers that some property transactions require a higher level of analysis than others. For example, some transactions may involve a parcel with clear development potential and many examples to serve as comparable sales. On the other hand, other

transactions may not have comparables and may require a detailed analysis of the potential to develop the parcel and the time and cost such development would incur. Absent content guidelines for appraisals, we do not know whether departments or grantees are being provided with appraisal reports that provide sufficient information to evaluate a particular property's value.

**Reviewing the Appraisal.** The review of the appraisal is an integral component of the appraisal process. Appraisals are either reviewed by licensed appraisers who did not conduct the initial appraisal or by nonappraisers, such as project managers involved in the acquisition transaction in the state department funding the acquisition. Appraisals reviewed by DGS are reviewed by one of two licensed appraisers who are responsible for the review of all appraisals submitted to DGS.

Our analysis found a couple of significant problems with the review of appraisals. First, department staff conducting appraisal reviews have varying levels of expertise. For example, while some departments have land acquisition staff with appraisal backgrounds and a good knowledge of the real estate market in particular areas, others lack this expertise. Second, there are no standards guiding how appraisal reviews are to be done. Take for example the level of review of an appraisal. Sometimes DGS does a review involving site visits and verification of the data used, while other times it does a "desk

“We have identified two features of the current appraisal process which diminish its independence.”

review” without verifying the sales data used in the appraisal. While different levels of appraisal review may be warranted depending on factors such as the complexity of the property acquisition, we found that there are no guidelines to assist DGS (or whomever else may be reviewing the appraisal) in determining what level of review is appropriate in any given situation.

### **STATE APPRAISAL PROCESS NEEDS MORE INDEPENDENCE**

The independence of the appraisal process from the influence of those directly interested in the transaction (such as the buyer or seller) is essential in order to ensure that the value of the acquisition is objectively determined. We have identified two features of the current appraisal process which diminish its independence. First, parties with an interest in the land acquisition often select the appraiser. Second, appraisals are not consistently reviewed by a licensed appraiser independent of the transaction.

***Parties Interested in the Acquisition Transaction Often Select the Appraiser.*** In the current appraisal practices used for state-funded resource acquisitions, an appraiser is often hired by a party who has a significant interest in the outcome of the appraisal, potentially jeopardizing the independence of the resulting appraisal. Although the appraiser is required by professional ethics to remain impartial and objective, the likelihood of pressure to arrive at a predetermined value opinion increases when the appraiser’s client has an interest in the outcome of the appraisal. For example, in a recent report on land acquisitions at the federal Bureau of Land Management (under USDO), The Appraisal Foundation (TAF) reported that in cases where the seller or a nonprofit land trust with an inter-

est in the transaction selects the appraiser and pays for the appraisal, there is a risk that the independence of the appraisal process can be jeopardized because the seller or land trust can exert too much influence on the process. While there is a fiscal benefit to the state in having another party pay for the appraisal, in such circumstances the state becomes less able to ensure that the appraisal meets specific standards and that there is an “arm’s length” distance between the seller and appraiser. Similarly, where appraisers are selected and paid for by a public agency acquiring the land, the TAF report found that the land-acquiring agency exerted a strong influence on the appraisers, particularly when the agency’s primary statutory mission was land acquisition.

### ***Opportunities for Independence of the Appraisal Review Function Are Not Maximized.***

The appraisal review function—which serves as a check on whether appraisals meet applicable standards—is another component of the appraisal process where independence is important. However, not all appraisals conducted for state-funded acquisitions for resources purposes are subject to review. This is the case mostly for grant-funded acquisitions, although some direct acquisitions, mainly ones of a low dollar amount, may also escape appraisal review by DGS. Even when appraisal reviews are not strictly required, nevertheless they are sometimes done. Unfortunately, in such cases, we found that appraisals were often “reviewed” by parties connected with, and therefore not independent of, the acquisition transaction. These parties include the department funding the acquisition. In such cases, the reviews are generally conducted by staff who are not licensed appraisers and are also the same staff negotiating the acquisition or awarding the grant to fund the acquisition.

## LACK OF PUBLICLY AVAILABLE APPRAISAL INFORMATION LIMITS ACCOUNTABILITY

***Basic Appraisal Information Generally Not Public Before Acquisition Is Complete.*** Current law generally allows departments to withhold from public disclosure appraisal information until after the transaction is complete. (Exceptions to this general rule are discussed below.) Most departments elect to do this, citing seller concerns about disclosure prior to the transaction's completion. Sellers have expressed concern that if appraisal information is publicly disclosed and the particular transaction is ultimately not consummated, the information may influence the decisions of a future buyer. In addition, sellers are concerned about making public details of their land, such as the condition of the property. As a result, generally little information related to the appraisal is made public before acquisitions are completed, thereby limiting opportunities for public or legislative oversight of these acquisitions.

In order to increase the availability to the public and the Legislature of appraisal-related information, recent legislation (Chapter 708, Statutes of 2004 [AB 1701, Laird]), placed new requirements on a select group of acquisitions—namely acquisitions of more than \$25 million of state funds that are funded by WCB or SCC. Acquisitions which meet these criteria require an independent appraisal and an independent appraisal review. The findings of the appraisal review (not the appraisal itself) must be made public ten days prior to a hearing of the land-acquiring agency authorizing the purchase. (By focusing the public disclosure on the appraisal review rather than the appraisal itself, the statute attempts to balance the need for legislative/public oversight of these acquisitions with the

sellers' concern about protecting proprietary information in the appraisal.) By increasing the disclosure of appraisal-related information for selected acquisitions, this legislation is a good first step. However, as noted, Chapter 708 does not apply either to acquisitions under \$25 million or to acquisitions funded by departments other than WCB and SCC, such as DPR or the state's many regional conservancies. In the recommendations section of this report, we discuss ways to increase the public availability of appraisal-related information by building on Chapter 708 to include a greater number of acquisitions that would be impacted by its requirements.

### ***Budget Notification Process Does Not Provide Appraisal Information for Legislative Evaluation.***

In order to increase legislative oversight of large resources-related acquisitions, the Legislature added Control Section 9.45 to the *2002-03 Budget Act*. This control section—continued in subsequent budget acts—requires departments to notify the Legislature before committing Propositions 40 and 50 bond funds for acquisitions in excess of \$25 million (*all funds*).

The *2007 Budget Act* extends the control section to also include acquisitions funded from Proposition 84 bond funds. By providing notification that the Legislature would not otherwise receive, this control section has increased legislative oversight of such

“...generally little information related to the appraisal is made public before acquisitions are completed, thereby limiting opportunities for public or legislative oversight...”

large acquisitions. However, as currently written, the budget control section does not require that the Legislature be provided with any appraisal-related information, nor does it specify any requirements for an appraisal or appraisal review. (The provisions of Chapter 708 do require a publicly released appraisal review, but only for those acquisitions by WCB and SCC which have a total cost exceeding \$25 million in *state funds*.) In the recommendations section of this report, we recommend revising the control section to further improve the availability of information necessary to enable legislative evaluation of significant acquisitions.

***Appraisal Records Are Not Easily Accessible.*** As a result of the multiple state agencies

involved in the appraisal process, appraisal documents for resources-related transactions are not centrally located. As a consequence, appraisal reviewers cannot readily access relevant information from previous land transactions which can be helpful in identifying comparable sales. Additionally, this impedes accountability because it makes public access to, and review of, appraisal documents more difficult.

***A Case Study Highlighting Problems With Appraisal Process.*** Please see the box on page 22 for a case study of a resources-related land acquisition that exemplifies a number of the issues and problems with the state's resource appraisal process that we have identified above.

## RECOMMENDATIONS FOR IMPROVING THE APPRAISAL PROCESS

**Overview.** As discussed in this report, we have identified a number of shortcomings in the current appraisal process used by state agencies in acquiring land or funding grants for conservation purposes. We believe the Legislature has the opportunity to address these shortcomings and establish an appraisal process that produces impartial valuations; complies with appraisal standards; and provides well-supported, properly prepared and documented value opinions for use in a department's decision making. As discussed in this section, we recommend the enactment of legislation establishing standards for resources-related appraisals. We further recommend the appraisal process for these resource transactions be consolidated outside of the Resources Agency in order to achieve an appropriate level of independence. Lastly, we outline a couple of steps the Legislature can take to reduce the risk of

potential unwarranted tax benefits being claimed by the seller in these transactions.

Our recommendations largely focus on improving an existing appraisal process in place for use by resource departments when funding land acquisitions. For some transactions and departments, our recommendations may result in adding steps to the current process, or subjecting more transactions to components of the appraisal process than currently, thereby potentially adding time to complete some transactions. However, we think that this added time is worth the "cost" given that it is serving to protect the state's investment in the purchase of natural resource properties.

### **Establish Standards to Facilitate Oversight**

As discussed earlier, there are no appraisal guidelines addressing the complexities particular

to resource transactions. The lack of standards makes it difficult to facilitate quality control or accountability. Below we recommend the establishment of a specific set of resources-related standards so that the appraisal process for state-funded acquisitions is held to the same level of accountability regardless of the funding agency or whether the state is funding a grant or a direct purchase.

**Require Appraisals to Adhere to Standards.** We recommend the enactment of legislation requiring the development of a specified set of appraisal standards for resource conservation acquisitions. (We discuss the responsibility for the development and adoption of these standards in a later section of the report where we recommend a revised administrative structure for the appraisal process.) We further recommend that such standards serve as the basis for all state-funded resource acquisitions, regardless of the type of acquisition (grant or direct purchase), or the resource agency funding the acquisition.

It is important to note that we do not envision the standards being overly prescriptive. Rather, the standards would provide some basic parameters to ensure that the state is consistently provided with reliable appraisal-related information to help it make decisions about purchasing or funding land acquisitions for resource conservation purposes. Cognizant of the workload

implications of specifying an appraisal process, we recommend that there be thresholds that would need to be met before certain steps in the appraisal process (such as the requirement for an independent review of the appraisal) or other relatively workload-intensive requirements would be triggered. The thresholds could be

stated in terms of a level of state funding contribution or total purchase cost for the land acquisition.

Specifically, we recommend that standards address the following issues:

- **Commissioning the Appraisal.** Standards should provide guidelines for who are the appropriate party(ies) for commissioning an appraisal under various circumstances. While appraisals could be commissioned by various parties (for example, the resource department directly funding the acquisition, DGS, the seller, or a land trust serving as an intermediary), we

think that, as a general-principle, the appraiser should be hired and given instructions by a party who is independent from the acquisition function. Under most circumstances, appraisals could be commissioned by DGS in order to provide the requisite independence to the process.

“We believe the Legislature has the opportunity to...establish an appraisal process that produces impartial valuations, complies with appraisal standards, and provides well-supported, properly prepared and documented value opinions...”

### **A CASE STUDY HIGHLIGHTING POTENTIAL PROBLEMS WITH THE APPRAISAL PROCESS: THE CARGILL SALT PONDS ACQUISITION**

An example of the problems that can arise from the current appraisal process comes from the state and federal government's 2003 purchase of 16,500 acres of the Cargill salt ponds in the San Francisco Bay Area. In the Cargill transaction, the state paid \$72 million towards a \$100 million purchase price of the salt ponds, with the goal of converting the salt ponds to wetlands for fish and wildlife habitat. The state and federal resource agencies involved in the transaction relied on a 28-month old appraisal conducted at the request of the U.S. Fish and Wildlife Service by two private appraisers. (The difference between the selling price and the \$243 million appraisal value used by the seller for tax purposes—\$143 million—was later claimed by the seller as a charitable contribution for a federal tax deduction.)

The Cargill salt ponds acquisition reveals a number of issues and problems with the appraisal process for purchasing resources lands, as discussed in the following sections.

**Complex Issues; Rife With Uncertainty; Making and Disclosing Assumptions.** First, this case shows the potential complexity and inherent uncertainty of issues faced by appraisers in resources-related acquisitions. In the case of this transaction, these issues relate particularly to two matters—an assessment of the property's economic development potential and an assessment of its value if it were purchased by parties seeking an environmental restoration project. (We discuss below the tie between a property's "restoration potential" and its market value.) Evaluating these issues requires the appraiser to make a number of assumptions. Accordingly, the credibility of the appraisal is fundamentally affected by how the appraiser makes the assumptions, uses them in arriving at a property's appraisal value, and discloses them in the appraisal document.

As in other resources-related acquisitions, the property being acquired in the Cargill transaction consisted of large tracts of mainly open space (mostly wetlands) that, in light of past environmental degradation, would require restoration. The restoration potential of the land is particularly relevant in this case because, pursuant to federal requirements concerning wetlands, lands such as the Cargill salt ponds are potentially purchased and restored by developers who are legally required to mitigate (offset) the adverse environmental impacts on wetlands of their development projects elsewhere.

The calculation of this so-called "mitigation value" of the salt ponds, however, was rife with uncertainty and required a number of assumptions. In this particular case, the appraisers assumed that the salt ponds could generate substantial revenue by being bought and restored as wetlands by the San Francisco International Airport Authority. Specifically, this *assumed* that the airport authority would: (1) approve and begin construction on a project to extend the airport's runways into the San Francisco Bay and (2) chose to meet most of its mitigation requirements for such development by restoring the Cargill lands as wetlands, as opposed to

### **A Case Study Highlighting Potential Problems With the Appraisal Process: The Cargill Salt Ponds Acquisition**

performing mitigation at competing sites. However, as a matter of fact, the airport authority had effectively terminated any such expansion project well before the Cargill transaction was finalized. The appraisal used by the state and federal resource agencies to finalize the Cargill transaction—then 28 months old—was not updated to reflect this. Nor did the appraisal state the impact on the property’s value should any of the multiple assumptions about the property’s mitigation value fail to materialize.

Regarding the Cargill property’s development potential, the appraisers concluded that the highest and best use of a particular portion of the property was a major yet-to-be approved mixed-use development with houses, retail, and office space. Such a development would not only have required future local land use approvals, but also the future regulatory approvals of several state and federal resource agencies, including the Department of Fish and Game, the Regional Water Quality Control Board, the San Francisco Bay Conservation and Development Commission, the United States Environmental Protection Agency, the Army Corps of Engineers, and the National Marine Fisheries and Wildlife Service. In this particular case, the appraisers assumed that all of these agencies would provide the necessary approvals for such a development.

In disciplinary hearings concerning one of the two appraisers who jointly conducted the appraisal relied upon by the state for the Cargill acquisition, the administrative law judge found that the appraiser’s assessment of the property’s value was “based largely upon unstated extraordinary assumptions and hypothetical conditions.” In other words, the judge found that the appraiser, in assessing the property’s mitigation value and its development potential, presumed as fact information that was uncertain, and consequently failed to disclose in the appraisal document that there was such uncertainty and how the assessed value would change should any of the assumptions upon which it was based prove to be false. The judge also found that there was no evidence reasonably supporting the appraiser’s assumption that all of the required government approvals would be granted to permit the mixed-use development that the appraiser assumed could be developed on the property.

***Problems When Independence Lacking Between the Resource Acquisition Agencies and the Appraisers.*** Second, the Cargill case shows the potential problems that can arise when the appraisal process is not conducted sufficiently independent of the resource agency’s acquisition process. In this particular case, the appraisers were chosen by, and given their instructions by, the federal resource agency (the U.S. Fish and Wildlife Service) intending to purchase the property. In a misconduct complaint brought against the appraisers by the state Attorney General’s Office in 2005, it was alleged that the appraisal was not conducted independently and objectively. In the subsequent administrative law proceeding, the judge made findings raising similar

*(continued)*

**A Case Study Highlighting Potential Problems With the Appraisal Process: The Cargill Salt Ponds Acquisition (continued)**

concerns. For example, the judge found that the U.S. Fish and Wildlife Service instructed the appraisers to assume as fact circumstances related to Cargill's salt making rights that were not true, and that the appraisal did not disclose that its valuation of these rights was based on a hypothetical condition.

**Consequence of Limited Public Disclosure of Appraisal Documents.** Third, the Cargill case reveals how oversight (legislative and otherwise) of resources-related transactions can be made difficult by constraints on the public disclosure of appraisal-related documents. During negotiations on the Cargill transaction, the state and federal resource agencies were asked by numerous parties, including legislators and taxpayer groups, to publicly disclose the appraisal, but the resource agencies refused (as they had the legal right at that time to do so). When the appraisal documents were ultimately made public subsequent to the transaction being completed, information came to light that led the state Attorney's General Office to bring a misconduct complaint against the appraisers, as noted above. The complaint alleged that numerous errors were made by the appraisers in valuing the salt ponds, bringing into question the appraisal's credibility as a necessary information tool used by the state and federal resource agencies in making their acquisition decision.

➤ **Qualifications of the Appraiser.** Complex transactions require specific appraisal expertise. The standards should provide guidelines for the minimum expertise required for various types of resource appraisal assignments, such as appraising the value of conservation easements. At a minimum, we think that the standards should require that only licensed appraisers be hired (the state's licensing body is the Office of Real Estate Appraisers). An appraiser who is licensed by the Office of Real Estate Appraisers is required to follow USPAP when conducting appraisals in the state. Regardless of which state entity is ultimately charged with hiring appraisers, we recommend that the process for selecting private appraisers be

made subject to the state contracting procedures for professional services found in Section 4525 of the Government Code. This particular contracting process uses the professional qualifications necessary to perform the service as the basis for awarding contracts and provides the authority for the state agency to negotiate a contract with the "best qualified" firm.

➤ **Timing of the Appraisal.** Guidelines should address at what point in the acquisition process appraisals should be completed. As a general principle, appraisals should be conducted *prior* to the purchase price being negotiated, but not too far in advance of the purchase negotiations so as not to reflect outdated



information or incorrect assumptions affecting the property's value.

- **Information That Must Be Provided to the Appraiser.** Guidelines should identify the types of information, such as reports documenting environmental contamination, that should be provided to and considered by the appraiser in making the valuation determination.
- **Scope of Analysis and Level of Information Provided in Appraisal Report.** Standards should specify the matters requiring an analysis when conducting an appraisal, differentiated by the circumstances of the property transaction at issue, thereby guiding the level and type of information that is included in the appraisal report. For example, standards should address how the appraisal should be conducted in a case of very few comparable sales (a not uncommon situation in resources-related transactions), and how the analysis on this matter should be documented in the appraisal report.
- **Use of Government and Conservation Transactions as Comparable Sales.** Guidelines should provide the cautionary notes and address how to appropriately use other land sales to government agencies and other conservation transactions as comparables, given the potential for the sale price in such transactions to reflect something other than FMV. As noted earlier, this potential exists, for example, because the sale price in such transactions may be intentionally set below FMV to trigger a charitable contribution for the

seller or because there were relatively few comparables to guide that sale price.

- **Addressing Assumptions About Development Potential in Determining Highest and Best Use.** The assumptions made about the development potential of a parcel, which is considered as part of the appraiser's evaluation of a property's highest and best use, can have a significant impact on the valuation result. As such, guidelines should address minimum requirements for determining and documenting those assumptions in the appraisal report. For example, the guidelines should require that the appraisal report document all of the permits that would be required for a development project to proceed, the assumptions being made about the likelihood of each of such permits being granted, and the impact on the valuation should any of the assumptions prove to be false.
- **Valuation of Conservation Easements.** Standards are particularly necessary for the valuation of conservation easements since, even though this type of property acquisition is relatively common for resource transactions, the USPAP only minimally addresses this valuation issue. A similar recommendation was made by the federal Senate Finance Committee. At the time this analysis was prepared, the Appraisal Institute was considering the development of such standards. If developed, these would be helpful in the development of standards to apply to the state's resource agencies.

➤ **Appraisal Review.** Standards should at minimum address when an appraisal review is required, the type of appraisal review that is requested, who should do the appraisal review, and how the information should be conveyed in the report document resulting from the review. For example, regarding the latter, we recommend that the standards require that the opinion of value be presented as a single number or a range reflecting the full FMV, rather than as an “at least” or “not less than” amount. We think that in instances of complicated appraisals, it may be appropriate for appraisals to be reviewed by a qualified panel of appraisers. The IRS has adopted a similar idea, in that it establishes a panel to review the value of charitable art contributions. We recommend that the appraisal review standards also include criteria for when the use of such a panel should be necessary.

**Use USPAP as a Starting Point.** We recommend that as a starting point, these standards incorporate USPAP which are widely considered the universal basic operating standard for the appraisal profession in the United States. However, in order that the standards be sufficient to provide guidance for resource transactions, we recommend the adoption of supplemental standards to specifically address issues related to conservation transactions. The development of such supplemental standards is contemplated by USPAP. The development of such supplemental standards could be informed by the supplemental standards developed for federal land acquisitions and referred to as the “Yellow Book.”

**Tap Outside Expertise for Development of Standards.** Regardless of which state entity is

charged with developing and adopting the appraisal standards discussed above (we discuss restructuring the administrative structure for the appraisal function below), we think that the state could benefit from outside expertise in establishing the technical details of these standards. For example, this could be achieved by contracting with an organization with appraisal expertise such as the Appraisal Institute or TAF.

### **Improve Independence of the Appraisal Process**

**Addressing the Need for Independence.** As discussed earlier, independence is a key component of an effective appraisal process. However, we find that the current appraisal process for resource conservation transactions—which typically involves significant participation by the land acquiring agency itself and/or a land trust or seller—is not structured to facilitate such independence. In order to achieve such independence, we think that the existing administrative structure for carrying out appraisal functions needs to be revised. We recommend focusing the appraisal function for resource conservation transactions primarily in an entity outside of the Resources Agency. This is intended to improve the independence of the appraisal function by separating the acquisition function (programmatic decision making as to which properties to purchase) from the appraisal function, thereby avoiding the influence of the acquisition function on the appraisal function.

**A Reorganized Administrative Structure Could Lead to Other Improvements.** In addressing the need for independence in the appraisal function, a reorganization of the administrative structure could trigger other benefits. For example, if the appraisal function were reorganized in

a *single* entity outside of the Resources Agency, this potentially could result in efficiencies and allow for the development of staff expertise. A major benefit of establishing the appraisal function for resources acquisitions in a single location would be improved accountability because there would be a single point of contact to hold accountable for implementing state standards, making quality control easier.

***The DGS Could Assume Appraisal Function.*** We recommend that the responsibility for the various components of the appraisal function be placed in DGS, for a couple of reasons. First, DGS already has the appraisal review responsibility for the bulk of resources-related direct acquisitions. Second, DGS is better positioned than the resource departments themselves to be objective in performing the appraisal function because it does not have a specific, mission-driven interest in resource conservation transactions. Similar actions have been implemented federally at USDOT in order to improve the independence of the appraisal function. Specifically, an independent, centralized appraisal unit within USDOT, separate from the umbrella department's resource bureaus and offices, was established. As with the development of standards, and as was done in the case of USDOT's restructuring of the appraisal function, we think that the state would benefit from outside expertise in establishing the specific mechanics of how the appraisal function would operate in DGS.

We think the adoption of standards specific to resource transactions as recommended previously, along with increased training for DGS staff on implementing the standards, would help to make the resource appraisal process more uniform. As a result, resource acquisitions with

similar characteristics will be subject to the same scope of the appraisal process.

We think additional appraisal activities at DGS could be carried out using a mix of state and contract staff. (Contracting provides important appraisal flexibility, allowing the state to tap outside expertise with a wide variety of valuation experience.) While the level of staffing needed by DGS would depend on the number of acquisitions that are occurring, which generally varies according to bond fund availability, we do not think that adopting our recommendations would add substantially to DGS's workload. The additional workload would be focused in two areas—(1) commissioning the appraisal and (2) reviewing appraisals for grant-funded acquisitions. According to DGS staff, there is not a lot of administrative workload connected with commissioning appraisals, and this task could be handled by one or so additional personnel-years. In addition, we think that by giving DGS control at the front end over the quality of the appraisal to be reviewed (by being tasked with commissioning the appraisal), the appraisal review function could be handled more efficiently than currently.

As for the additional workload connected with reviewing appraisals for grant-funded acquisitions, this would very much depend on the number of such acquisitions in any given year. We think that an objective review of the appraisals for this type of acquisition, conducted by DGS as a third party to the transaction, would add significant value at a relatively low cost. The DGS estimated its costs to review a single appraisal to be around \$5,000 to \$10,000 for a fairly significantly sized transaction, although its review costs can be several times more for large, particularly complex transactions. To contain these additional costs, statute could set an ac-

quisition cost threshold (such as \$5 million, for example) for property being acquired using state grant funds before the appraisal review requirement would be triggered. At the very least, DGS would likely require an additional two to three personnel-years to handle the grant-related appraisal review workload.

Given that most funding for resource conservation acquisitions or grants comes from bond funds (and will likely continue to do so given voter approval of Proposition 84), it is appropriate that funding for the appraisal function come largely from bond funds. The appraisal function can be viewed as part of the “due diligence” that should be done when making a bond-funded investment and therefore chargeable to the bond funds. Using bonds for this purpose is also consistent with recent bond measures that generally require the bond fund to be the sole source of funding for administrative costs to implement the bond.

### **Increase Public Availability of Appraisal Information**

As discussed earlier, for most transactions, little information is made public about the appraisal (including for purposes of legislative review) before the transaction is complete. As a result, it is difficult to exercise legislative oversight because information is lacking to evaluate the reasonableness of the purchase price in advance of the commitment of public funds. It is understandable that appraisal information involving transactions solely between private parties involving solely private funds is not made public due to privacy concerns. However, we think that when public funds are involved, there is a broader public interest at stake which justifies increased disclosure to the public of appraisal-related information. In such situations, concerns about the release of proprietary informa-

tion can be addressed by setting statutory parameters on what appraisal documentation is required to be disclosed.

***Expand Existing Appraisal Review Public Disclosure Requirements.*** Currently, statute requires that an appraisal review be made public before the acquisition is complete only for those purchases made directly by WCB or SCC which exceed \$25 million in state funds. Therefore, grants and acquisitions by state agencies other than WCB or SCC do not fall under this requirement. We recommend expanding this public disclosure requirement for appraisal reviews to all resources-related land transactions, regardless of funding agency, dollar amount of the transaction, or whether the transaction is a grant award or a direct land acquisition. Making public the appraisal review should neither increase significantly the transaction costs nor compromise proprietary information. This is because once an appraisal review is completed, making it public will result in only minimal costs. Furthermore, as is currently done when the findings from appraisal reviews are made public, proprietary information is not included.

***Legislative Notification Process Should Be Improved for Better Oversight.*** Current budget act provisions require that a state agency notify the Joint Legislative Budget Committee prior to the expenditure (directly or through grants) of Propositions 40 or 50 bond funds for projects with a total cost from all fund sources greater than \$25 million. (The *2007-08 Budget Act* extends the control section to Proposition 84-funded acquisitions.) The notification must provide specified information, including a detailed description of the project proposed for funding. However, these notifications are not required to include other information which would facilitate

legislative oversight, including a copy of the appraisal review. In order for such notification to better assist the Legislature in its review of the proposed transaction, we recommend the notification requirement be amended to additionally require the submittal of an appraisal review that has been approved by DGS. We further recommend that the notification requirement apply to all fund sources and also be placed in statute, rather than the annual budget act, to ensure that the requirement is ongoing.

### **Take Steps to Avoid Unwarranted Tax Benefits**

Many of the recommendations discussed in this report could also serve to guard against California taxpayers claiming unwarranted tax benefits from state-funded resource conservation acquisitions. (A tax benefit arises when the seller reports that the property was sold to the state or other charitable recipient at less than FMV, thereby creating a “charitable contribution.”) An improved appraisal function could provide valuable information to assist the state’s tax agency (FTB) in its compliance activities. Specifically, an effective appraisal function for state-funded resource conservation transactions could provide a credible, independent verification of the taxpayer’s (seller’s) claim in a related charitable contribution. (Currently, FTB has indicated that it has very little expertise to verify the appraised values submitted on charitable contribution claims that may result from a state-funded resource conservation acquisition.) We recommend a couple additional actions in order to ensure that the appraisal information is in a format that is most useful to FTB in enforcing compliance with the tax codes.

- First, we recommend the standards for appraisal reviews (that we recommend earlier be adopted) require that the opinion of value in the report resulting from the appraisal review be presented as a single number or a range reflecting the *full* FMV. This would be instead of the current practice of sometimes using an at least or not less than amount. For example, in 2004, state funds were used to acquire a conservation easement on the Hearst Ranch in San Luis Obispo County. As part of the transaction, the sellers also agreed to donate land to the state. The DGS reviewed the appraisal report and determined the value of the total transaction to be “not less than \$110 million (the sales price).” When an at least or not less than amount is used, the appraisal review cannot effectively be used by FTB to assist it in evaluating the legitimacy of any charitable tax deduction. This is because FTB instead requires information on the subject property’s full FMV.
- Second, we recommend the enactment of legislation requiring FTB to use the state-approved appraisal value supporting the purchase price in a state-funded resource conservation acquisition as the basis for evaluating a charitable contribution later claimed by the seller. If the taxpayer is using a value different than the state’s value, then FTB should seek an explanation to reconcile the difference. This will allow FTB to easily identify at least the most clearly egregious taxpayer claims. In evaluating the charitable claim,

the FTB should have the flexibility to make appropriate adjustments to the state's approved value, in light of new information relating to the property's value

that may develop in the intervening period between the state's appraisal review and the seller making the tax claim.

## CONCLUSION

Land acquisition is an important tool for resource conservation. However, we find that the current appraisal process used by state agencies in acquiring land for conservation purposes needs improvement. Our recommendations are

summarized in Figure 3. Specifically, we recommend the enactment of legislation to require the development of comprehensive appraisal standards that would apply to state-funded resource acquisitions. We further recommend that the

**Figure 3**

### Improving the Appraisal Process for Resource Conservation Acquisitions Summary of LAO Recommendations

- ✓ **Establish Standards to Facilitate Oversight**
  - Enact legislation requiring the development of a specified set of appraisal standards for resource conservation acquisitions. The standards should include guidelines for:
    - commissioning the appraisal,
    - the qualifications of the appraiser,
    - the scope of the analysis and level of information provided in the appraisal report,
    - the timing of the appraisal in the transaction process,
    - the use of government and conservation transactions as comparable sales,
    - addressing assumptions about development potential,
    - information that must be provided to the appraiser,
    - the valuation of conservation easements,
    - appraisal review, and
    - the independence of the appraiser.
- ✓ **Improve Independence of the Appraisal Process**
  - Revise the existing administrative structure for the carrying out of the appraisal function to provide greater independence and promote objectivity of the appraisal function.
  - Place various components of the appraisal function in the Department of General Services (DGS).
  - Contract with an organization with appraisal expertise for the development of recommendations for the specific mechanics of how the appraisal function would operate in DGS.
- ✓ **Increase Public Availability of Appraisal Information**
  - Expand existing public disclosure requirements.
  - Improve legislative notification process for better oversight.
- ✓ **Take Steps to Avoid Unwarranted Tax Benefits**
  - Require the state-approved appraisal value used to support the purchase price in a state-funded resource conservation acquisition to be the basis, with appropriate adjustments, in any related evaluation by the Franchise Tax Board of the value of a charitable contribution claimed by the seller.

administrative structure for the appraisal function be revised to achieve a higher level of independence and to improve efficiency and accountability. Finally, we make recommendations for improving tax compliance by strengthening the

connection between the appraisal process in state-funded resource acquisitions and the tax-related review of charitable contributions that may be claimed by taxpayers in connection with such transactions.

