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RE: What is an Appraisal Inspection and how does it differ from other types of inspection?

The Problem: The term “inspection” is used by a wide variety of participants across the real estate transaction chain. Each group uses the term to mean something different, created confusion in the marketplace. No consensus exists for the application of this term to the work of real estate appraisers.

Proposed Solution: (1) Create an appraiser-specific definition for “inspection” in USPAP called “appraisal inspection”. This will clarify an appraiser’s role in the real estate transaction process and distinguish the appraisal process from other professional services conducted in conjunction with a transaction for any given property. By including a clear definition for an “appraiser’s inspection” in the definitions section of USPAP, the definition will become part of state law since the states have adopted USPAP into their laws in all 55 jurisdictions. This will reduce exposure of appraisers to lawsuits and relieve the courts from having to wrestle with clarifying the appraiser’s role.

(2) Re-write Advisory Opinion 2 to reflect the updated definition and to further clarify the appraiser’s role when viewing property and collecting data.

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## Background

### *Common Definitions for Inspection*

The term “inspection” is commonly defined as meaning things like an *examination*, *measurement*, *gauging* and *comparison* – all of which apply to some degree to the activities of a real estate appraiser when observing property. Other definitions include phrases such as *examine closely*, *especially for errors*, *to scrutinize* and *to view closely and critically*. Any of us with military experience know all too well just how much scrutiny can be applied in some inspections, and how the attitude and judgment of the person conducting the inspection weighs on the results.

### *Reasons for Inspecting*

BusinessDictionary.com says that “an inspection determines if the material or item is in proper quantity and condition, and if it conforms to the applicable or specified requirements.” Regulatory bodies conduct inspections of their charges to ensure compliance with applicable rules and regulations.

The act of “inspecting” is a process of discovery, either to discover something that was previously altogether unknown – such as a pre-purchase inspection of a used car or an inspection of produce by a retailer to determine its suitability for sale, or to discover whether or not something meets a specific set of predetermined requirements, such as a banking audit, or a safety inspection of an oil tanker to ensure its fitness for carrying hazardous materials.

## Advisory Opinion 2

In USPAP, Advisory Opinion 2 clarifies the purpose for inspecting property in the context of developing an appraisal on line 15:

*The primary reason for inspection of a property is to gather information about the characteristics of the property that are relevant to its value.*

This section of the advisory opinion also uses the expression “personal observations” of the appraiser in lieu of “inspection” in the next sentence starting on line 17:

*While there are other ways to gather such information, in many cases the personal observations of the appraiser are the primary source of information regarding the subject property.*

Although the title of this Advisory Opinion is “Inspection of Subject Property”, the body of this advisory opinion does not distinguish a subject property from comparable properties (sales, listings, etc.) or discuss inspecting other materials that are commonly used to “gather information about the characteristics of the property that are relevant to its value.”

The advisory opinion essentially overlooks the issue of defining “inspection” by deferring to the scope of work, saying that it is the appraiser’s responsibility to determine the appropriate scope of work, including the degree of inspection necessary to produce credible assignment results.

### ***Types of Real Estate Related Inspections***

Advisory Opinion 2 acknowledges that a variety of types of inspection is possible, and attempts to differentiate an appraiser’s inspection from other types of inspection:

*An inspection conducted by an appraiser is usually not the equivalent of an inspection by an inspection professional (e.g., a structural engineer, a licensed home inspector, a Renaissance art expert)*

This section is problematic from several perspectives. First, in using the phrase “inspection professional” to refer to other types of inspectors, it is hard not to infer that the appraiser’s inspection is not a professional inspection. Diminishing the professional standing of an appraiser, however inadvertently, seems contradictory to one of the overriding purposes of USPAP of promoting and maintaining a high level of trust in appraisal practice. If an appraiser is expected to “inspect” a property, but is not an “inspection professional”, shouldn’t someone else be doing the inspecting?

Second, identifying a partial list of “inspection professionals” by specialty or field of expertise suggests a specific focus that these particular inspection professionals will bring to their

inspection, but we fail to describe a specific focus for the appraisal professional's inspection. This has resulted in a lot of confusion in the market. A common response from many home buyers when asked if they had their property inspected is "yes", but when asked for more details about their "inspection", many believe that the appraisal inspection *was* the home inspection and that the appraisal inspection covered specifics of electrical, plumbing and structural components of the property. The single point of confusion traces to use of the term "inspection".

The third problem here is that this paragraph makes clear that there are many types of inspections, but many of the potential inspection types are made by specialists other than appraisers. Yet, in the very next section of the Advisory Opinion starting on line 61, it refers to the "infinite variability of inspections" without clarifying whether it is appraisal inspections or all inspections that are "infinite" in variability. This adds to the confusion about who performs which inspections and where one specialty ends and another begins. Unless appraisers are capable of performing every conceivable type of inspection, there cannot be an "infinite" variability of inspections, at least as contemplated for an appraiser; wide variability perhaps, but infinite seems implausible.

Fourth, in using the term "usually" in the sentence "an inspection conducted by an appraiser is usually not the equivalent of inspection by an inspection professional (e.g. a structural engineer, a licensed home Inspector, a Renaissance art expert), suggests that there are occasions when an inspection conducted by an appraiser might be the equivalent of an inspection by another inspection professional. This contradicts other guidance in USPAP, specifically the Ethics Rule, which says:

*An appraiser must not misrepresent his or her role when providing valuation<sup>1</sup> services that are outside of appraisal practice.*

This portion of the advisory opinion should be reworded to make clear that an inspection conducted by an individual acting as an appraiser is *never* intended to be the equivalent of an inspection conducted by another inspection professional, lest the appraiser risk misrepresenting his or her role.

### ***Inspecting Comparable Sales***

Historically, the extent to which comparable sales are inspected is not the same as the extent to which a subject property is inspected. When the appropriate level of inspection for the subject property in a given assignment only requires viewing the property from the public street, the extent of inspection for both the subject property and comparable sales may well be identical. However, in many appraisal assignments the depth and detail of information gathered by the appraiser about the subject property exceeds the depth and detail of information gathered about the comparable sales, resulting in a more thorough viewing (a complete interior walk-through for example) of the subject property than of comparable properties.

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<sup>1</sup> The conduct section of the ethics rule should be amended to remove the word "valuation". This rule would be more effective if it read "an appraiser must not misrepresent his or her role when providing ~~valuation~~ services that are outside of appraisal practice".

Since the focus of this paper is to establish a definition for an appraisal inspection as it relates to a subject property only, my thoughts on clarifying the process of inspecting comparable sales is reserved for a separate communication.

## **Why we should define “appraisal inspection” in the definitions section of USPAP**

There are many good reasons for defining “appraisal inspection” in the definitions section of USPAP. To the same extent that appraisers and users of appraisal services benefit from definitions<sup>2</sup> for “Appraisal Practice” to distinguish it from “practice” in general, “Appraisal Review” to distinguish it from more general types of review, and “Appraiser’s Peers” to distinguish it from peers in general, a specific definition for “Appraisal Inspection” would serve appraisers and users of appraisal services alike by providing a meaningful distinction between what an appraiser does in the property visit and data gathering process compared with the more general definitions of inspection, as well as distinguish the appraiser’s inspection process from other specialized inspection types such as structural inspections, code compliance inspections, termite inspections and so forth.

An additional benefit of providing a definition of “Appraisal Inspection” in the definitions section of USPAP is that the definitions are part of what we commonly call the “enforceable” part of the document. By including a definition for “Appraisal Inspection” in this part of the document, state regulators are relieved from having to develop their own (and often inconsistent) understandings of how to apply state law to the activities of an appraiser in disciplinary matters. This also becomes a benefit to the courts by having a single, uniformly applicable definition to reference in cases brought against or by appraisers in the court system.

In the case of residential real property, recent requirements requiring mortgage lenders to provide borrowers copies of all valuations used by the lender in the lending decision at least three days before closing makes clarifying the appraiser’s role for the benefit of consumers and appraisers alike an urgent matter. The alternative to establishing a definition of the appraisal is likely to be having the court system do it for us.

In practical terms, “inspection” by itself, especially when used in the context of residential real property is commonly understood to mean the home inspection; in a 2004 report on home inspections by the United States General Accounting Office (GAO) (Office), the prevailing reference used to the home inspection process is simply the word inspection. Although efforts have been made by the Department of Housing and Urban Development (HUD) to clarify the difference between a home inspection and an appraisal, it is clear that a large number of home buyers<sup>3</sup> do not understand the difference. Clarifying the work of an appraiser by providing a definition for appraisal inspection will be a direct benefit to consumers by adding much-needed clarification to this otherwise confusing issue.

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<sup>2</sup> Through the end of 2013, USPAP also contains a definition for “Appraisal Consulting” to distinguish it from other types of consulting.

<sup>3</sup> According to the GAO study, about 36% of all home buyers using FHA insured financing in 2002 appeared to understand the differences between appraisals and home inspections; the estimate rises to only about 42% when considering only those buyers who got home inspections.

Although the GAO study is dated, it is the most recent study of its kind, and there is no evidence to suggest that homebuyer understanding of this issue has dramatically improved.

### **Proposed Definition**

#### **Appraisal Inspection:**

The direct, personal observations of an appraiser made in the course of visiting or viewing tangible property that is the subject of an appraisal assignment.

Comment: The reason for an appraisal inspection is to gather information about the characteristics of the property that are relevant to its use and value. The information collected is used by the appraiser to aid the understanding of current use, general condition and functional utility of any property improvements, and when applicable, to develop an opinion of the highest and best use of the property.

The extent of an appraisal inspection is a function of the scope of work employed by an appraiser which can vary based on assignment conditions and the intended use of the assignment results.

An appraisal inspection is deliberately non-invasive and is specifically limited to those things readily observable without the use of special testing or equipment. An appraisal inspection is not intended to replace or be the equivalent of inspections by other specialized professionals, such as appropriately qualified/credentialed home inspectors, structural engineers, energy efficiency auditors, commercial machinery and equipment specialists, etc.

#### ***Miscellaneous***

A partial list of potential inspections that might be sought in connection with the transfer and/or financing of real property include:

- Termite
- Radon
- Roof
- Plumbing
- Electrical
- Structural
- Soils
- Flood Hazard
- Energy Efficiency
- Code Compliance

An “inspection” of the USPAP document reveals a variety of modifiers used with the term “inspection”. Some of the modifiers found in USPAP used with the term inspect or inspection<sup>4</sup> include:

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<sup>4</sup> There are 163 instances of “inspect” or variants of “inspect” within USPAP 2012-2013 which would need to be reviewed and potentially modified in the context of this new definition.

- Property
- Personal
- Physical
- Minimum Level (of)
- Degree (of)
- Appraiser's
- Exterior-only
- Interior
- Preliminary
- Final
- Specific

## **Conclusion**

Adding a specific definition for an appraisal inspection in the definitions section will eliminate confusion between the work of an appraiser and the work of other providers of professional services whose work also includes some level of inspection of the property. Further, the modifiers listed above when used in conjunction with an appraisal inspection will add further clarity for the benefit of appraisers, users of appraisal services, regulators and the courts. The overriding objective of USPAP to promote and maintain public trust in appraisal practice will be improved by making this change.

Respectfully submitted,

William King