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ENGAGEMENT LETTERS

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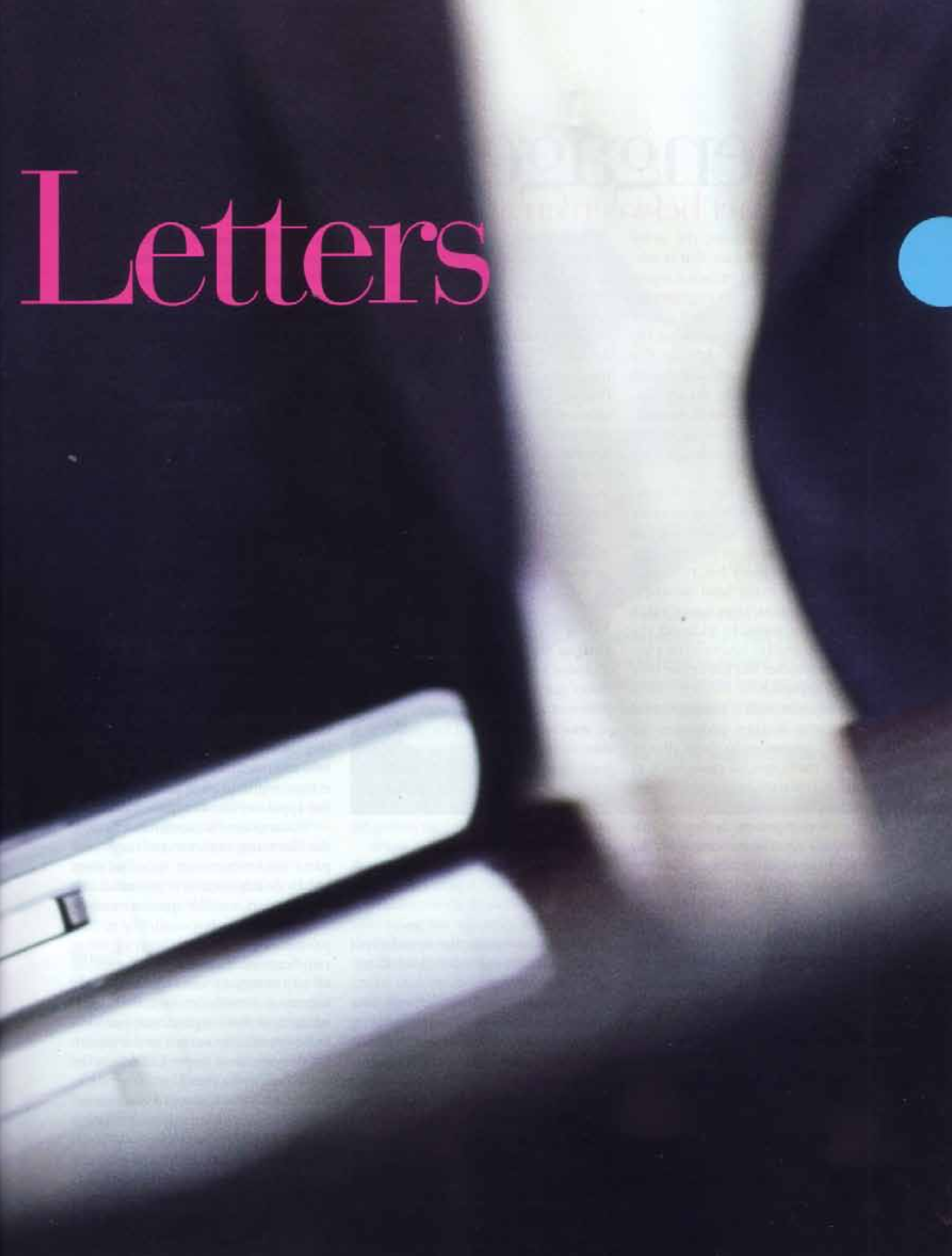
WRITING EFFECTIVE Engagement

BECAUSE EVERY APPRAISAL ASSIGNMENT IS UNIQUE, THE INFORMATION INCLUDED IN AN ENGAGEMENT LETTER SHOULD REFLECT THE PRESENT ASSIGNMENT'S REQUIREMENTS.

Letters



An engagement letter is a contract between an appraiser's firm and its client.

However, in many cases, the same amount of effort and care that is taken in writing the actual valuation report is not taken in writing the engagement letter. The engagement letter sets clients' expectations, lets them know what the deliverable will be and what the appraiser expects of them, and should take steps towards limiting the appraiser's liability and scope of work. As such, the same amount of effort, or maybe even more, should be expended in writing the engagement letter.

The goal of this article is to provide a roadmap to use in constructing or reviewing an engagement letter. The article is not aimed at providing a "foolproof" template because that would have too many legal ramifications and because appraisers value many different assets. In addition, the goal is not to explain *how* to write a letter; each appraiser has his or her own style and approach.

The article will cover general engagement letters provided by appraisal companies to their clients. There are many special cases, such as financial institutions, government agencies, and attorneys, that may issue their own engagement letters or that may require specific structures for the letters. These variations are too numerous to cover effectively in this article.

What Should Be Covered in an Effective Engagement Letter?

Grade school children learn that a good paper should answer the following:

- Who?
- What?
- Why?
- Where?
- When?
- How?

A good engagement letter is no different. The following sections will address each of these points by asking a variety of questions that the authors hope are answered in an engagement letter.

An additional source of guidance in developing a good engagement letter is the Uniform Standards of Appraisal Practice (USPAP). The Scope of Work section of USPAP indicates that the appraiser needs to define the problem, determine the scope of work necessary to develop credible results, and disclose the scope of work. This is a great outline for any engagement letter.

The following discussion will outline some suggested questions that should be answered in an engagement letter.

Who?

One of the primary pieces of data included in an engagement letter is the "who" question. This can take on many different aspects such as:

Who is the client? This question is one of the first questions appraisers have to answer when they begin the appraisal process. The engagement letter should spell out the client as completely as practical by at least stating his or her:

- Full name.
- Title.
- Company.
- Address.

If this is not done, the actual client or the intended user (discussed shortly) may be in question.

In many cases, the client will be a representative of the company being appraised, but in other situations, this may not be true. The client may actually be an attorney, a bank, a taxing authority, a company proposing to purchase another entity, or many other parties. The client is typically the one paying the bill, but is also the "owner" of the appraisal. As such, defining the client is extremely important.

USPAP requires the clients and the intended users to be defined. What better place to do this than in the engagement letter?

In some cases, the client may want to remain anonymous. In this case, USPAP allows the client to be referred to in general terms, but the complete identity has to be included in the work file. There also has to be a note in the appraisal report that the identity of the client has been omitted in accordance with the client's request, and that the report is intended for use only by the client and any named intended users.

Is the Client the Only Intended User? If Not, Who Else Is an Intended User? USPAP requires that all of the "intended users" be defined and mentioned in the report along with the client. Identification of any potential intended users assists the appraiser in setting the scope of work and determining how to present the results in a way that is meaningful to all of parties to whom the appraiser has a responsibility.

The appraiser is accountable to both the client and any intended users. Any party who receives an appraisal does not, by default, become an intended user of the report, and the appraiser may or may not have a responsibility to that person, depending on legal or other ramifications. Therefore, the definition of any intended users is extremely important. As with the client, the intended users, at their request, may not want to be specifically named in the report. The requirements under USPAP are the same here as for the client.

Defining the client and any intended users in the engagement letter assures that the client agrees with the appraiser's understanding of who the client and intended users actually are. If not, this should give the client the opportunity to ask questions or bring up any additions or objections.

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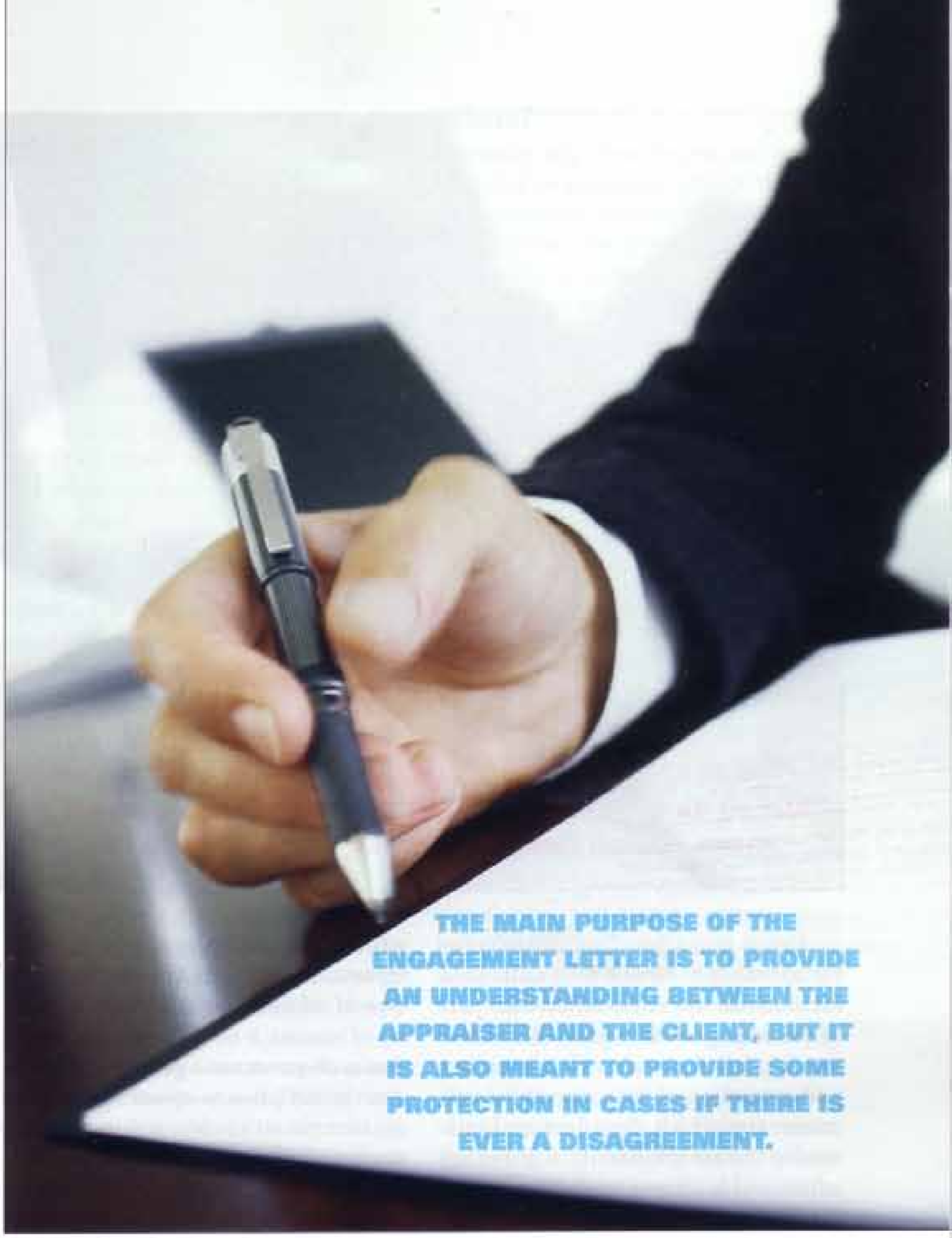
Who Will Be Doing the Appraisal? This may be important to clients for a variety of reasons. In the world of real estate, all appraisers have to be licensed and certified. Typically, real estate appraisers cannot practice in states in which they are not licensed. In other cases, such as for banks and some other institutions, there is a requirement that an accredited appraiser (such as an Accredited Senior Appraiser (ASA) of the American Society of Appraisers or another applicable accreditation) be used. Stating who will do the appraisal and citing his or her certifications assure the client that the person performing the appraisal has the proper credentials.

If the client is under the impression that a senior-level or accredited person is performing the valuation and he or she finds out (after the fact) that the assignment was performed in its entirety by a junior-level person, the client may be upset and require that the project be redone. If, however, the engagement letter states that junior level personnel will perform the majority of the analysis and that an accredited or experienced appraiser will be supervising the work, the client has been informed. An unsigned engagement letter offers the client the opportunity to review his or her requirements or understanding with the appraiser and to make an informed decision.

What?

The "what" in the engagement letter allows the appraiser to reemphasize his or her understanding of the client's (and intended user's) requirements as well as to reemphasize what he or she expects of the client. "Reemphasis" is used because all of the data contained in the engagement letter *should* simply be a confirmation of data previously agreed on by the appraiser and the client.

The following are some examples of the "what" questions that should be addressed in a meaningful engagement letter:

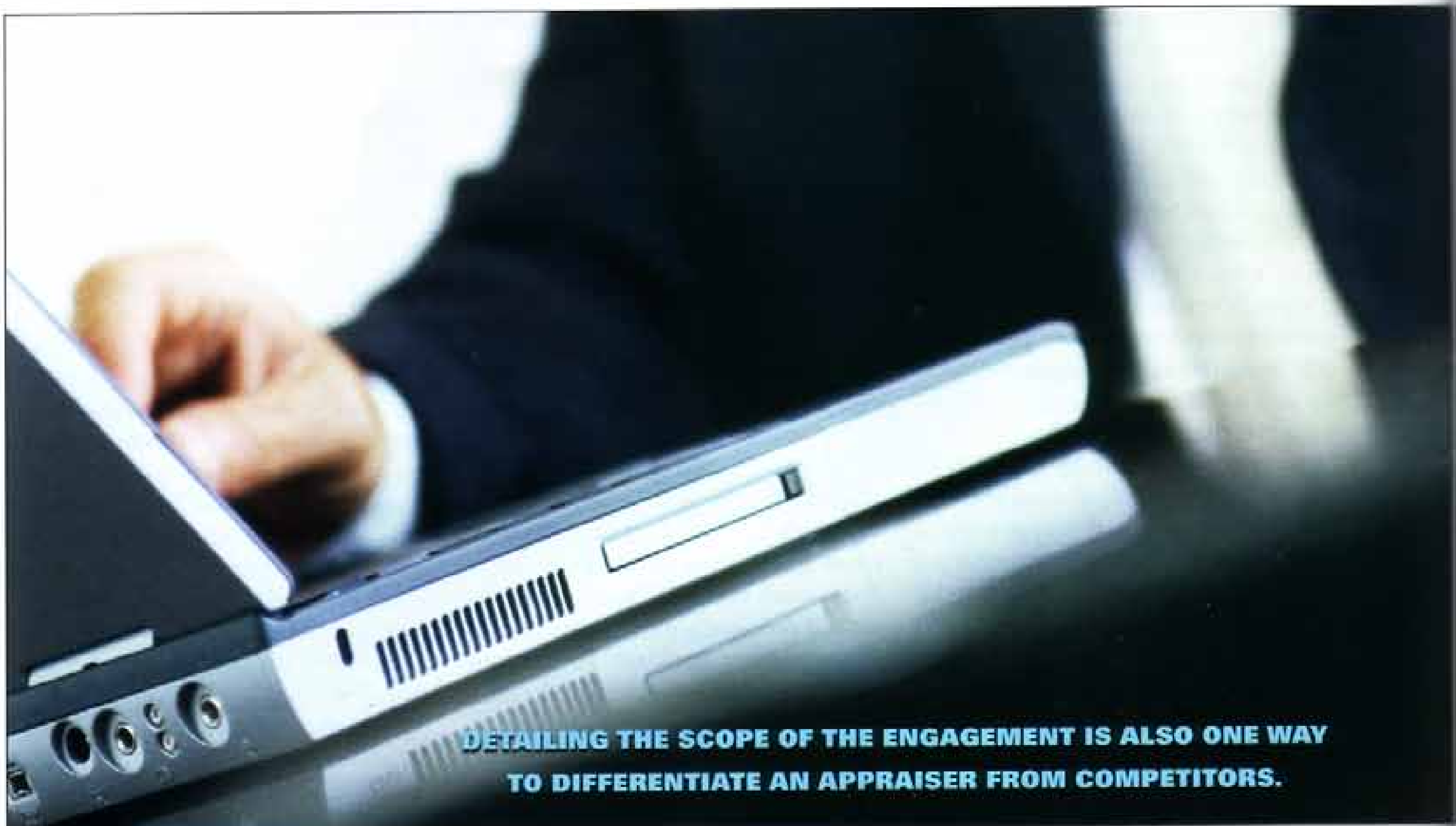


THE MAIN PURPOSE OF THE ENGAGEMENT LETTER IS TO PROVIDE AN UNDERSTANDING BETWEEN THE APPRAISER AND THE CLIENT, BUT IT IS ALSO MEANT TO PROVIDE SOME PROTECTION IN CASES IF THERE IS EVER A DISAGREEMENT.

What Is the Appraiser Going to Appraise? In order to set the appropriate project scope (and the fee), the appraiser needs to define the nature (including the quantity and type) of the assets that are to be appraised. For the tangible asset appraiser, this may entail real estate, personal property, and potentially inventory. For the intangible appraiser, this may entail any number of identifiable intangible assets.

It is to the appraiser's benefit to be as detailed as practical when addressing the assets that will be valued, and just as importantly, those that will not be valued. For example, if the appraiser states that he or she is going to appraise all of the tangible assets of a company, the client may conclude that this includes *all* of the personal and real property when the appraiser's intention was just to value the machinery and equipment.

It is best to clarify (in detail) exactly which assets are to be valued, to ensure that all parties agree and there are no surprises when the report is issued. There is nothing more disheartening than a client receiving what he or she believes is an "incomplete" appraisal that does not contain all of the assets the client wanted appraised. Many appraisals are time-sensitive as well as fee-sensitive. If the scope is not detailed in the engagement letter and the client receives less than he or she expects, it may put the client in a bad position, and in turn, will not bode well for the appraiser. At a minimum, the appraiser may lose a client or the client may sue the appraiser. Neither is a good outcome.



When?

The "when" can have many different implications in a valuation. Some of the implications that should be detailed in a good engagement letter include:

What Is the Valuation Date? This is probably the second most important question to be asked (the first being the "why" or purpose of the valuation). Depending on the purpose of the appraisal, the valuation date may be current, retrospective, or prospective. In most cases, the valuation date is dictated by sources outside the appraiser's control. However, the appraiser is bound to provide a valuation that meets the economic factors as of the valuation date.

The appraiser and the client must be on the same page with regards to the valuation date. If not, much research and effort may be wasted. The engagement letter is a good place to assure that everyone agrees before the project begins.

When Is the Report Due? Stating the date on which appraiser expects to deliver the draft and final reports is another way to assure that the appraiser and the client are moving towards the same goal. This protects both the appraiser and the client. The client knows when to expect the reports, and knows they will be delivered in time to meet his or her needs and protects the appraiser from unknown deadlines. If the deadline becomes tighter, the engagement letter can again become a source of reference and guidance for increasing the fee if required to meet the new deadline. Qualification terms such as ".....the draft report will be provided within 60 days of the receipt of all requested information...." or other similar verbiage can also protect the appraiser.

When Will the Inspection Be Performed? When Will the Initial Kickoff Meeting Be Held? These clarification questions are also good topics that may be covered in the engagement letter. In some cases, however, addressing these questions in the engagement letter is not as critical as in other cases. For example, if the delivery timetable is particularly tight, having the inspections performed or the initial information-gathering meeting or conference called prior to a certain date may be critical to allow adequate time for the analysis. If this is critical, it is best to let the client know ahead of time.

How?

The "how" question can cover a wide range of subjects in the engagement letter such as:

What Is the Scope of the Appraisal? What Value Approaches Will Be Used? In essence, these questions address how the actual appraisal will be performed. The more detailed the answers to these questions in the engagement letter, the better the appraiser will be at managing the client's expectations and understanding of why the fee is what it is.

Detailing the scope of the engagement is also one way to differentiate an appraiser from competitors. For example, if an appraiser is going to provide information above and beyond what competitors would provide, it is good to tell this to the client up front. It may help secure the valuation when there is tight competition for the project. The appraiser can also use the engagement letter to educate the client as to the various approaches to value and as to which approaches are or are not applicable to the particular valuation.

How Will the Report Be Delivered (Electronically, Hard Copy, Both)? This question assures that the appraiser outlines exactly what he or she intends to supply to the client. As stated previously, this allows the client and the appraisal company an opportunity to make sure that the deliverables meet the client's needs.

How Much Will Be Charged for the Service? How About the Payment Terms? How Will Expenses Be Compensated or Included? These three questions revolve around the payment of fees and expenses. This is probably the most important information from the standpoint of the appraisal firm. In some cases, the expenses may be included in the fee, while in others the expenses may be in addition to the fee. Additionally, outlining a schedule of payment (either by date or event, such as "upon communication of verbal values" or "upon issuance of draft report") is a great benefit for both parties.

Another topic that seems to be increasingly an issue with the number of reviews and other follow-up efforts required (for valuations performed for financial reporting, tax appeals, and litigation related valuations, etc.) is how much time is the appraiser dedicating to this review or follow-up effort. Is this time included in the initial fee, or is the client expected to pay additional fees for these services? The present authors are seeing others address this issue and are implementing dedicated wording to cover this subject in their engagement letters. Several engagement letters that the authors have seen specifically state that a certain number of hours are dedicated to the review process and additional follow-up work, and that any hours after that will be charged at a defined rate.

Special Considerations

The main purpose of the engagement letter is to provide an understanding between the appraiser and the client, but it is also meant to provide some protection in cases when there may be a disagreement between the parties. Specific wording will not be offered, because that may be construed as providing legal advice. All wording of this type should be developed, or at least reviewed, by an attorney. However, some of the subjects that the appraisal company should consider are the following:

- If a conflict does arise, in which state will the conflict be settled?
- If a conflict does arise, how will it be handled (by the courts, by a jury, by arbitration, etc.)?
- Is the agreement separable, or is it valid only in its complete format?
- What rights does the client have to the report? Can it be provided to others? Can the fact that an appraisal was performed be divulged by either party?
- How are any indemnification agreements or "hold harmless" agreements to be addressed or enforced?
- What is the maximum liability of the appraisal company? Is it tied to the fee for the services provided?
- Who is responsible for court and attorney's fees if a conflict arises?
- Is there any liability on either side for consequential, incidental, indirect, economic, special, exemplary, or punitive damages incurred, such as loss of revenue, anticipated profits, or business?
- How are additional work requests (or scope changes) to be handled?
- How will either side be notified if additional work needs to be approved, or the project has to be stopped for some reason?

In addition, the engagement letter is usually a good forum to review and disclose a brief outline of the certification, the general assumptions and limiting conditions, and any extraordinary assumptions or hypothetical assumptions (if known) that will accompany the report. USPAP requires that all of these sections be predominantly presented in the final report. The sections can be either integrated into the engagement letter or added as exhibits to the letter. This provides full transparency between the parties so there are no surprises when the reports are issued.

General Comments

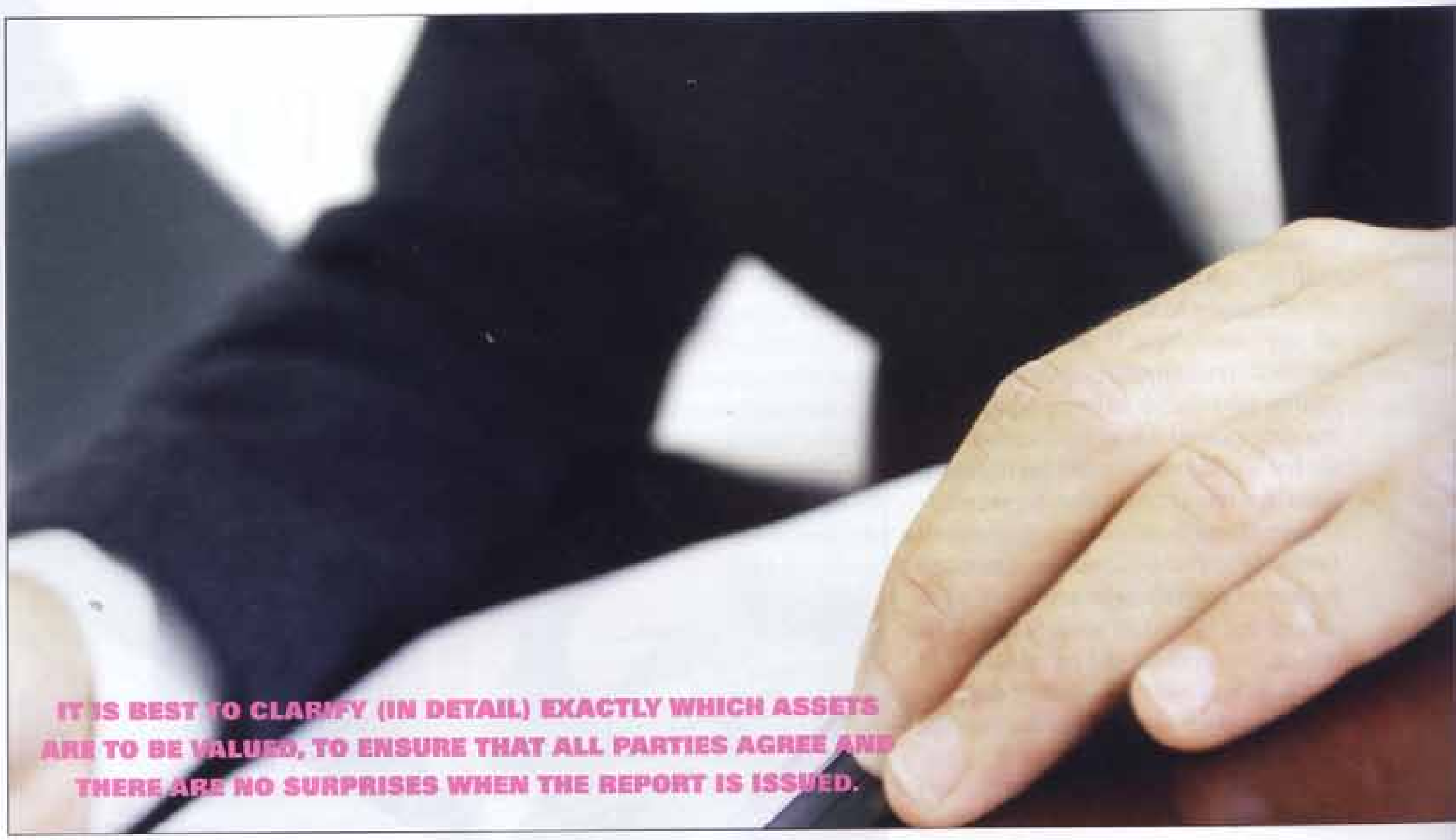
Here are some general pointers regarding a good engagement letter:

- The letter should tell the client what to expect and help limit "scope creep" and the appraiser's liability. A good engagement letter should easily allow both parties to identify efforts and analysis that are above and beyond the initial scope (and fee) of the engagement.
- The appraiser's engagement letter becomes the contract with the client. The appraiser should make sure to receive a signed copy of the engagement letter back from the client. The signature provides some "proof" that the client understands and agrees to the terms of contract.
- The clearer the letter is, the better it is for both the appraiser and the client. It helps the engagement move along more smoothly and should assure that there are no surprises when the report is delivered. The main purpose of any engagement letter should be to set and manage the client's expectations.
- A "good" engagement letter should include the following (in one form or another):

1. Introduction.
2. Purpose of the valuation.
3. Valuation date.
4. Valuation scope.
5. Identification of the assets and locations or entities to be valued.
6. Premise of value.
7. Report format.
8. Staffing.
9. Timetable.
10. Fees and terms of payment.
11. Special considerations.
12. Assumptions and limiting conditions.

Conclusion

Every appraisal assignment is unique, and the information ncluded in the engagement letter should reflect needs that are specific to the assignment at hand. Taking the time to structure the engagement letter in a way that properly addresses all of the appraiser's and the client's needs, as outlined in this article, will result in significant benefits to both the appraiser and the client. A well written engagement letter may not win an appraiser every assignment, but it may prove invaluable should something happen while the appraiser is engaged in an appraisal assignment that differs from the initial understanding with the client. ●



This is also a good opportunity for the appraiser to outline the locations or divisions the appraiser believes are part of the engagement. Again, this allows the appraiser to reiterate his or her understanding of the scope of the valuation (on which the effort and ultimately the fee are based). If there are additional locations or divisions, or if the appraiser mentions a facility or division that is not to be valued, this gives the client an opportunity to clarify the scope.

What Will Be Provided to the Client as Far as Deliverables. The engagement letter should detail the form of the final deliverable as well as the number of reports the client should expect. For example, if the appraiser is planning to provide only hard copies of the appraisal, and the client wants a "living document" such as an Excel spreadsheet or other format, it is best to know this prior to beginning the assignment. Another situation that the appraiser should know about ahead of time is if the appraiser is going to send hard copies and the potential client accepts only PDF copies of reports because he or she is environmentally focused.

Another potential area of concern may be inclusion of an extensive process write-up or photographs in the final reports. Some clients may not want this type of information included for a variety of reasons. It would be good to know that a client wants a general company description prior to spending an inordinate amount of time writing lengthy discussions of each product line and detailed descriptions of the company assets (whether tangible or intangible).

An additional area that should be covered in the engagement letter is the form of the report that the client will be receiving (i.e. a self-contained report, summary report, or restricted report (for real or personal property), or an appraisal report or restricted use appraisal report (for business valuation)). This may also require some client education on the part of the appraiser,either in the initial interview stage or in the engagement letter. The type of report may significantly increase the amount of work, and the fees required by the appraiser. The appraiser wants to assure that he or she meets or exceeds the client's expectations, but also wants to set expectations so that the client knows exactly what it is getting for the monies spent.

Most appraisers can accommodate a variety of deliverable formats, but they need to know up front what is expected. Appraisers may have a standard package of deliverables, but clients (and intended users) may have little to no experience dealing with professional appraisers or may have had expectations set by past appraisal assignments. The engagement letter is a good place to make sure that everyone is on the same page.

What Are the Value Concepts Needed for the Engagement? Each appraisal assignment has a specific purpose (addressed momentarily in the section on "why"). The why establishes the value concepts the appraiser needs to use in the valuation. In some cases (such as appraisals performed for the IRS or appraisals performed for financial reporting purposes) the definition of value may be a "given," but in other cases, the appraiser needs to establish the proper valuation defintion.

In all cases, however, the appraiser must interpret for the client and intended users what the *proper* definition means for a specific set of circumstances. Often the client believes it knows the appropriate valuation premise that will be to its "greatest benefit," regardless of the proper concept that should be used. An example would be a request to value the assets at fair market value for financing, or to value the entity as a non-operating operation when it is actually a going concern for tax purposes. Typically, banks and other financial institutions require some form of liquidation value. It is sometimes up to the appraiser to educate the client as to the proper level of trade or valuation premise that should be used for a specific assignment. The engagement letter is a good place to reconfirm this with the client.

By specifically defining and explaining the proper premise of value in the engagement letter, the appraiser is doing the client and himself or herself a service. Not only is the appraiser educating the client, but he or she is also providing some coverage for the appraiser's potential liability at a later date if the client disagrees with the premise of value as defined.

What Data Will Be Required from the Client or Company? What Are the Client's Responsibilities? These two questions go hand in hand. In most appraisals, the appraiser cannot perform the valuation without a certain amount of cooperation from personnel at the company being valued. Certain information (such as balance sheets, cash flow projections, asset listings, and inventory reports) will have to be gathered as part of the analysis.

It is beneficial to detail, as clearly as is practical, what the client is expected to provide as far as information and time commitments are concerned. For example, if the appraiser will require a lengthy meeting with company management to review the financial data or would like a company escort to accompany him or her on facility tours, this should be explicitly outlined in the engagement letter (or an addendum to the letter). Many appraisers send out a detailed questionnaire once an engagement is approved, but the present authors have found that a client likes at least some indication of the level of effort he or she will need to put forth prior to receiving the questionnaire.

Additionally, this will indicate to the client that the appraiser will require its input, again setting the client's expectations.

What Is the Timing of the Valuation? Since most valuations are tied to some sort of deadline, such as a property tax or income tax filing, or a court date, all of the parties involved need to know the timeline of events. It is advantageous to outline when the appraiser expects to obtain certain information from the client, when the field inspections are expected to occur (if there are any), when the analysis and draft report are to be completed, and when the final report is expected to be issued.

This timeline may be susceptible to change, depending on many different variables, but stating it in the engagement letter gives all of the parties a "best-case scenario" for the project. Also, it potentially protects the appraiser from client backlash for not concluding a valuation on time if the client misses deadlines.

Why?

The "why"of an engagement letter helps the appraiser set the scope of the entire valuation. As such, it is extremely important that the "why" be clearly stated in the letter.

Why Is the Appraisal Being Requested? What Is the Purpose? This is really the first question that should be asked by any appraiser who is setting the scope of an assignment and should be a predominant part of the engagement letter. The "why" sets the stage for the rest of the appraisal scope and helps the appraiser establish the following (among other things):

- Appropriate premise of value.
- Amount of research and due diligence that needs to be performed (scope of work).
- Potential approaches to value that will be used.
- Need for additional follow-up efforts (such as the audit review portion of an appraisal performed for financial reporting, or testimony in a court-related manner).
- Type of report that needs to be generated.

Contrary to the beliefs of *some* appraisers, the authors of this article believe that an appraisal *cannot* be properly performed unless the specific purpose (or purposes) is known.

Where?

When an appraiser begins setting the scope of an assignment, he or she typically cannot assume that all of the assets to be valued will be near his or her office. Increasingly, appraisers are being asked to value companies that are multinational in nature and that may have locations scattered in all corners of the globe. As such, it is extremely important that the appraiser clarify the following:

Where Is the Main Headquarters Located? Where Are the Facilities to Be Appraised? Are All of the Facilities (or Assets) Going to Be Valued or Just a Subset of the Facilities (or Assets)? What Locations, If Any, Are Going to Be Visited? Initially, this may seem as if it applies to the tangible asset appraiser more than it does to the intangible or business enterprise appraiser, but the locations of the various assets affect all of the disciplines in some way. Obviously, if there are assets in countries other than the one in which the appraiser is located, additional time and travel expenses may be incurred, and additional time may need to be added to the delivery timeline. Also, different countries (at least at this time) have differing accounting practices and report their data in various languages. This may require additional time or costs for the appraiser. Detailing any assumptions (such as receiving the data with major categories labeled in English, or indicating that the appraiser will or will not visit foreign locations) sets the expectations of the client which, in turn, should minimize any "surprises" when the analysis is completed.

Another related topic is the size of the facilities. For the real estate or machinery & equipment appraiser, the facility size can indicate how much time is needed to spend on site. If the sizes are not as expected, more or less time may need to be spent on each location. If the various facility sizes are explicitly called out in the engagement letter, any differences in effort due to larger-than-expected facilities can be quantified and billed accordingly. Without this information described in the engagement letter, the appraiser may have little to no recourse if he or she spends more time than initially estimated.