UNIT SIX 6

THE APPRAISAL PROCESS

LEARNING OBJECTIVES

When you have completed this unit, you will be able to

- identify the steps in the appraisal process,
- explain the importance of determining the appraiser's scope of work,
- define retrospective value,
- describe situations in which a retrospective value appraisal is used, and
- discuss each of the three major approaches to appraising.

KEY TERMS

cost approach
Department of Housing and Urban Development (HUD)
depreciation
Fannie Mae
Federal Housing Administration (FHA)
fee simple estate
Freddie Mac
highest and best use
income capitalization approach
leased fee estate
leasehold estate
letter of engagement
life estate
retrospective value
sales comparison approach
scope of work
secondary mortgage market
Uniform Residential Appraisal Report (URAR)
Uniform Standards of Professional Appraisal Practice (USPAP)

■ OVERVIEW

At its simplest, an appraisal presents the appraiser's opinion of a property's probable monetary value on the open market. There is much more involved in even the simplest appraisal than a mere estimate of value, however.

In deriving a final opinion of value the appraiser will use one or more of the approaches to appraising—the sales comparison approach, the cost approach, and the income capitalization approach. The manner in which the appraiser applies a particular approach may be determined by the type of property being appraised and the factors of greatest importance to buyers. A single-family rental house, for instance, would not be appraised using the same method of income valuation as would an office building, even though both properties may produce income.

This unit focuses on the basic definition of each of the value approaches. Also covered are the steps involved in the appraisal process, from the appraisal assignment through the final opinion of value.

■ STEPS IN THE APPRAISAL PROCESS

An appraisal begins with a specific assignment initiated by a **letter of engagement** to the appraiser, such as a request to estimate the market value of a single-family residence being considered for a mortgage loan. From that point, every appraisal requires the organized collection and analysis of data. Specific data about the property, general data about the surrounding area, and data applicable to the appraisal approach being used all must be researched.

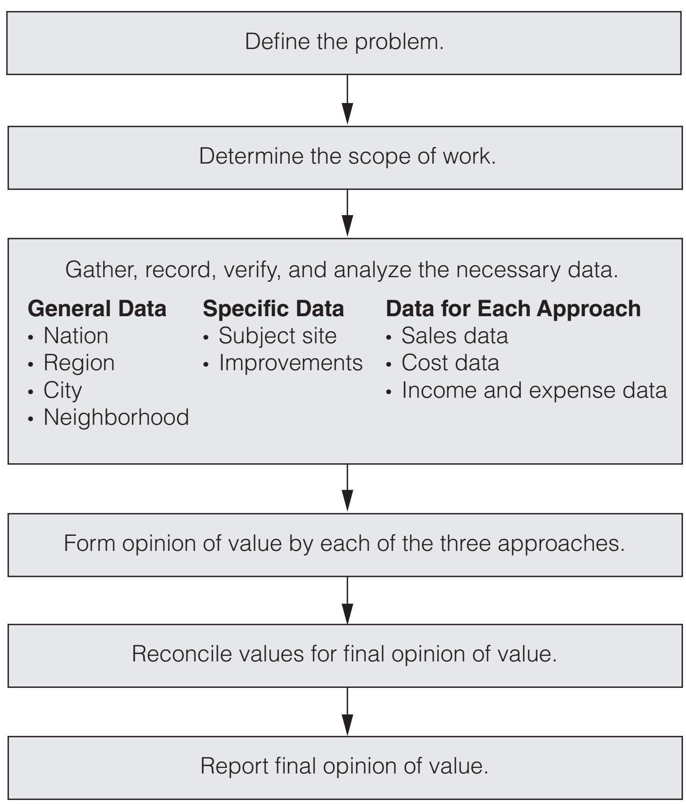
The flowchart in Figure 6.1 outlines the eight steps in the appraisal process. The steps, as follows, are described in the following list.

1. *Define the problem.*
2. *Determine the scope of work.* The first two parts of the appraisal process will determine the type and extent of the analysis the appraiser is to perform. The **scope of work** that is required will depend on the property, client, purpose of the appraisal, type and definition of value, effective date of the appraisal, and any conditions to the appraisal assignment. Identifying the appraisal problem includes the following:
   - *Identification and location of the real estate.* The property to be appraised must be identified by a complete legal description as well as a street address.
   - *Property rights to be appraised.* The typical appraisal assignment values the highest interest in real estate recognized by law—referred to as fee simple ownership—but the property interest may be less than full ownership, such as a tenant's interest in a lease or the right to use an easement or right-of-way, or title may be held in partnership, by a corporation, or jointly with other individuals.
   - *Definition of value to be estimated.* Because the word *value* can have many interpretations, the type of value sought should always be defined so the client fully understands the basis for the reported value.

- *Purpose and intended use of the appraisal.* The appraiser and client must agree on what the appraisal is to accomplish. The purpose of an appraisal relates to the type of value that is sought. The purpose of the greatest number of appraisals is to give an opinion of market value. However, appraisals can be made for many other purposes—for example, to find a property's replacement cost or its insurable value.

  The intended use or function of an appraisal is concerned with the reason the appraisal is being made, and the reasons may be varied. An appraisal may be made in a prospective purchase or sale, as the basis of a mortgage loan, to determine "just compensation" where property is taken under the right of eminent domain, to determine the terms of a lease, et cetera.
- *Effective date of the opinion of value.* What will be the effective date of the appraisal? It could be a date in the past, the date the property was inspected by the appraiser, the date the appraisal report was created, or some future date. Because real estate values are constantly changing, an opinion of value is considered valid only for the date specified.
- *Any special limiting conditions.* Normally, appraisals include a statement of qualifying and limiting conditions to protect the appraiser and to inform and protect the client and other users of the appraisal.

FIGURE 6.1
The Appraisal Process



These points will be covered in more detail later in this unit. Once the appraiser knows the property interest to be appraised and why the appraisal is necessary—whether for insurance purposes, to find market value, or simply to determine rental value—the approach(es) best suited to the property can be chosen. Occasionally, only one approach will be appropriate, because it will be the most reliable for some properties.

3. *Gather, record, verify, and analyze the necessary data.* Once the appraiser knows which approach(es) will be used, the information needed can be itemized. The appraiser must be familiar enough with the sources of information to state exactly what the sources for the particular case will be. The types of data needed must be collected and recorded for future use, and the data's accuracy must be verified. This step is the most critical in the appraisal assignment, as it will form the basis for the appraiser's opinion of the property's value.

   The appraiser compiles general data on the geographic and economic features of the nation, region, city, and neighborhood. Property location, as influenced by both natural and economic factors, is often of critical importance.

   Regardless of the interest being appraised, specific data on the subject property (including a detailed physical description) must be obtained. Particularly when comparable properties are to be found, the physical description should include all items likely to affect market value.

   Depending on the approach used, the appraiser also will gather sales data on comparable properties, cost data on construction of a like property, or income and expense data based on the property's history. All sources should be double-checked against other sources, especially when obtaining the sales price of a comparable property. In such a case, at least one of the sources should be a party to the transaction.

   Interpreting the relevant data is just as important as collecting it. In virtually every appraisal, the appraiser will begin this part of the appraisal process by conducting a **highest and best use** analysis that considers the market forces that influence the subject property to determine the property's most profitable use on which to base the final opinion of value. The analysis requires that the appraiser take into account the physical, legal, and locational attributes present in the real estate asset—the property that is the subject of the appraisal—and consider the extent to which those attributes fulfill the requirements of the marketplace. In other words, does the subject property's highest and best use satisfy the human needs that are revealed by such economic indicators as supply, demand, and absorption? The appraiser may conclude that the highest and best use of the land is not its present use.

4. *Form opinion of value by each of the three approaches*. Using the sales comparison approach, the appraiser analyzes available comparable sales data to form an opinion of value for the property under appraisal. In the cost approach, the cost new of property improvements, less depreciation of those improvements, is added to site value. Site value is found by using the sales comparison approach. In the income capitalization approach,

value is based on the rental income the property is capable of earning, after consideration of operating expenses and the property's expected rate of return.

5. *Reconcile values for final opinion of value*. The appraiser must correlate the information and decide what conclusions can be drawn from the volume of collected facts. The appraiser never simply averages differing value determinations. The most relevant approach, based on analysis and judgment, receives the greatest weight in determining the figure that most accurately reflects the value sought.
6. *Report final opinion of value*. Finally, the appraiser presents the conclusion of value in the reporting form requested by the client. As you will see in Unit 15, "Reconciliation and the Appraisal Report," the content of all appraisal reports should follow *USPAP*.

In Unit 8, "Data Collection," you will learn some of the many sources of information used in a real estate appraisal.

■ BEGINNING THE APPRAISAL PROCESS

Purpose and Use of the Appraisal

The appraiser begins the appraisal process by determining the scope of work required, based on the property being appraised, the type of value sought, and the purpose of the appraisal. Market value is the most frequently sought appraised value. Other types of value are highlighted in Unit 5.

Interests to Be Appraised

The form of legal interest being appraised must always be specified. Unit 3 described the various interests in real property, including fee simple, life estate, leasehold estate, and leased fee estate. Each of these interests can be appraised. The estimated value of the interest depends on the term of the interest, any limitations on property use during that term, whether the interest is transferable, and other factors.

A **fee simple estate**, or fee simple absolute, is the only form of ownership completely free of any other interest or estate. Even the owner of a fee simple absolute estate is subject to zoning and other governmental regulations, however. The appraisal also might be based on a partial interest, such as mineral rights.

A **leasehold estate** always has a definite termination date and can be valued for its remaining term. The **leased fee estate** that is retained by the owner of the fee simple interest also can be valued. Valuation of leasehold and leased fee estate is discussed in Unit 16, "Appraising Partial Interests."

The value of a **life estate** depends on the estimated remaining life span of the person against whose life the estate is measured. If that person is elderly, the life estate obviously has less value than it would if the measuring life were that of a healthy 20-year-old who did not engage in any unusually hazardous activities.

Date of the Opinion of Value

An appraisal may be made as of any date—past, present, or future. Most often, current value is sought, and the appraiser selects the latest date possible. Most appraisers select the date of inspection of the subject property as the effective date of the appraisal. Frequently, the value opinion sought is **retrospective value**, meaning the value as of a specific date in the past. A retrospective valuation is based on knowledge of the market prior to the current date and may be sought for such purposes as a property tax appeal, calculation of estate tax, condemnation proceeding, lease renegotiation, or divorce settlement. To estimate *future value*, the appraiser must extrapolate future market behavior based on current information and projected trends, an extremely difficult task. In any event, to avoid misleading the client, the appraiser should always state the assumptions under which the appraisal is made and any limitations on the use of the appraisal.

Limiting Conditions

WEB LINK

www.fanniemae.com
www.fanniemae.com/singlefamily
www.freddiemac.com

Fannie Mae and **Freddie Mac** are the major government-sponsored enterprises (GSEs) that purchase mortgages from primary lenders (such as banks), package the mortgages, and sell the resulting securities on publicly traded exchanges as part of the **secondary mortgage market**. The GSEs and other agencies do not expect an appraisal to be an all-encompassing process or the appraiser to spend an unlimited amount of time in preparing an appraisal report. The latest revision of the **Uniform Residential Appraisal Report** (**URAR**) form released by Fannie Mae and Freddie Mac incorporates a "Statement of Assumptions and Limiting Conditions" to help define the appraiser's role and specify the conditions under which the appraisal is made. Fannie Mae does not allow additions or deletions to the form when it is used as part of a Fannie Mae–related appraisal. For other transactions, the appraiser may draft a customized set of limiting conditions or add to this list, as appropriate for a particular property. Figure 6.2 shows the last three pages of the six-page URAR form, which replaced all previous versions of the URAR form for Fannie Mae appraisals as of November 1, 2005. The first three pages of the form, which include property information, data analysis, and opinion of value, appear throughout the remainder of this book.

You should note that the "Statement of Assumptions and Limiting Conditions" expressly limits the appraiser's responsibility for discovering and disclosing adverse conditions such as the presence of hazardous wastes and toxic substances on the property. In fact, the statement specifically provides that "the appraisal report must not be considered as an environmental assessment of the property." Nevertheless, in its guidelines for performing appraisals, Fannie Mae requires any lender who is informed by the real estate broker, property seller, purchaser, or any other party to a mortgage transaction that an environmental hazard exists on or near the property to record the information in the mortgage file, disclose it to the appraiser and the borrower, and comply with any other state or local disclosure laws. If the appraiser knows of any hazardous condition, it must be noted and its likely effect on the subject property's value must be commented on. The effect on value is measured by analysis of comparable market data as of the effective date of the appraisal; that is, the appraiser must use market data from properties located in the same affected area.

It is in the appraiser's best interest to learn as much as possible about the types of environmental risks that are likely to be encountered, so that their presence can be considered in the valuation process. Some of these conditions are mentioned in Unit 7, "Building Construction and the Environment." Of course, specific coursework in environmental hazards is necessary for anyone who intends to act as an environmental assessor or auditor.

Above all, the appraiser must disclose the limitations and assumptions under which the appraisal is made. The ***Uniform Standards of Professional Appraisal Practice (USPAP)*** stress in Standards Rule 2-1(c) that each written or oral real property appraisal report must "clearly and accurately disclose any extraordinary assumption, hypothetical condition, or limiting condition that directly affects the appraisal and indicate its impact on value."

The certification statement required by *USPAP* for all written property appraisals is discussed in Unit 15, "Reconciliation and the Appraisal Report."

FHA Appraisals

WEB LINK

www.hud.gov
www.hud.gov/offices/hsg/fhahistory.cfm

The **Department of Housing and Urban Development (HUD)** creates standards for **Federal Housing Administration (FHA)** appraisals. Appraisers who do FHA work must complete a three-page form describing, in detail, the physical condition of the home. The standards require that appraisers pinpoint "problems with plumbing, walls, ceilings, roofs, foundations, basements, electrical systems, and heating and air-conditioning systems; soil contamination; the presence of wood-destroying insects; hazards and nuisances near homes (such as oil and gas wells); lead-based paint hazards; and other health and safety problems."

To ensure that appraisers who do FHA work will meet these government standards, the HUD program includes HUD-mandated testing. An appraiser will be certified to do FHA appraisals only after passing the exam.

Figure 6.2
Uniform Residential Appraisal Report

Uniform Residential Appraisal Report

File #

This report form is designed to report an appraisal of a one-unit property or a one-unit property with an accessory unit; including a unit in a planned unit development (PUD). This report form is not designed to report an appraisal of a manufactured home or a unit in a condominium or cooperative project.

This appraisal report is subject to the following scope of work, intended use, intended user, definition of market value, statement of assumptions and limiting conditions, and certifications. Modifications, additions, or deletions to the intended use, intended user, definition of market value, or assumptions and limiting conditions are not permitted. The appraiser may expand the scope of work to include any additional research or analysis necessary based on the complexity of this appraisal assignment. Modifications or deletions to the certifications are also not permitted. However, additional certifications that do not constitute material alterations to this appraisal report, such as those required by law or those related to the appraiser's continuing education or membership in an appraisal organization, are permitted.

SCOPE OF WORK: The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

INTENDED USE: The intended use of this appraisal report is for the lender/client to evaluate the property that is the subject of this appraisal for a mortgage finance transaction.

INTENDED USER: The intended user of this appraisal report is the lender/client.

DEFINITION OF MARKET VALUE: The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby: (1) buyer and seller are typically motivated; (2) both parties are well informed or well advised, and each acting in what he or she considers his or her own best interest; (3) a reasonable time is allowed for exposure in the open market; (4) payment is made in terms of cash in U. S. dollars or in terms of financial arrangements comparable thereto; and (5) the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions* granted by anyone associated with the sale.

*Adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs which are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party institutional lender that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar for dollar cost of the financing or concession but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.

STATEMENT OF ASSUMPTIONS AND LIMITING CONDITIONS: The appraiser's certification in this report is subject to the following assumptions and limiting conditions:

1. The appraiser will not be responsible for matters of a legal nature that affect either the property being appraised or the title to it, except for information that he or she became aware of during the research involved in performing this appraisal. The appraiser assumes that the title is good and marketable and will not render any opinions about the title.

2. The appraiser has provided a sketch in this appraisal report to show the approximate dimensions of the improvements. The sketch is included only to assist the reader in visualizing the property and understanding the appraiser's determination of its size.

3. The appraiser has examined the available flood maps that are provided by the Federal Emergency Management Agency (or other data sources) and has noted in this appraisal report whether any portion of the subject site is located in an identified Special Flood Hazard Area. Because the appraiser is not a surveyor, he or she makes no guarantees, express or implied, regarding this determination.

4. The appraiser will not give testimony or appear in court because he or she made an appraisal of the property in question, unless specific arrangements to do so have been made beforehand, or as otherwise required by law.

5. The appraiser has noted in this appraisal report any adverse conditions (such as needed repairs, deterioration, the presence of hazardous wastes, toxic substances, etc.) observed during the inspection of the subject property or that he or she became aware of during the research involved in performing this appraisal. Unless otherwise stated in this appraisal report, the appraiser has no knowledge of any hidden or unapparent physical deficiencies or adverse conditions of the property (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) that would make the property less valuable, and has assumed that there are no such conditions and makes no guarantees or warranties, express or implied. The appraiser will not be responsible for any such conditions that do exist or for any engineering or testing that might be required to discover whether such conditions exist. Because the appraiser is not an expert in the field of environmental hazards, this appraisal report must not be considered as an environmental assessment of the property.

6. The appraiser has based his or her appraisal report and valuation conclusion for an appraisal that is subject to satisfactory completion, repairs, or alterations on the assumption that the completion, repairs, or alterations of the subject property will be performed in a professional manner.

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FIGURE 6.2
Uniform Residential Appraisal Report (continued)

Uniform Residential Appraisal Report

File #

APPRAISER'S CERTIFICATION: The Appraiser certifies and agrees that:

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.

2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.

3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

4. I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.

5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.

6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.

7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.

8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.

9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.

10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.

11. I have knowledge and experience in appraising this type of property in this market area.

12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located.

13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.

14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.

15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.

16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.

17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.

18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).

19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.

20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.

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FIGURE 6.2
Uniform Residential Appraisal Report (continued)

Uniform Residential Appraisal Report

File #

21. The lender/client may disclose or distribute this appraisal report to: the borrower; another lender at the request of the borrower; the mortgagee or its successors and assigns; mortgage insurers; government sponsored enterprises; other secondary market participants; data collection or reporting services; professional appraisal organizations; any department, agency, or instrumentality of the United States; and any state, the District of Columbia, or other jurisdictions; without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).

22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.

23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.

24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to, fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws.

SUPERVISORY APPRAISER'S CERTIFICATION: The Supervisory Appraiser certifies and agrees that:

1. I directly supervised the appraiser for this appraisal assignment, have read the appraisal report, and agree with the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

2. I accept full responsibility for the contents of this appraisal report including, but not limited to, the appraiser's analysis, opinions, statements, conclusions, and the appraiser's certification.

3. The appraiser identified in this appraisal report is either a sub-contractor or an employee of the supervisory appraiser (or the appraisal firm), is qualified to perform this appraisal, and is acceptable to perform this appraisal under the applicable state law.

4. This appraisal report complies with the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

5. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.

APPRAISER

Signature ____________________
Name ____________________
Company Name ____________________
Company Address ____________________
____
Telephone Number ____________________
Email Address ____________________
Date of Signature and Report ____________________
Effective Date of Appraisal ____________________
State Certification # ____________________
or State License # ____________________
or Other (describe) __________ State # __________
State ____________________
Expiration Date of Certification or License ____________________

ADDRESS OF PROPERTY APPRAISED
____
____

APPRAISED VALUE OF SUBJECT PROPERTY $ __________

LENDER/CLIENT
Name ____________________
Company Name ____________________
Company Address ____________________
____
Email Address ____________________

SUPERVISORY APPRAISER (ONLY IF REQUIRED)

Signature ____________________
Name ____________________
Company Name ____________________
Company Address ____________________
____
Telephone Number ____________________
Email Address ____________________
Date of Signature ____________________
State Certification # ____________________
or State License # ____________________
State ____________________
Expiration Date of Certification or License ____________________

SUBJECT PROPERTY

☐ Did not inspect subject property
☐ Did inspect exterior of subject property from street
Date of Inspection ____________________
☐ Did inspect interior and exterior of subject property
Date of Inspection ____________________

COMPARABLE SALES

☐ Did not inspect exterior of comparable sales from street
☐ Did inspect exterior of comparable sales from street
Date of Inspection ____________________

VALUATION APPROACHES

The basic problem when buying or selling real estate is deciding what it is worth. To derive an opinion of value, the appraiser uses three traditional valuation methods: the sales comparison approach, the cost approach, and the income capitalization approach. Each approach uses many of the principles defined in Unit 5. In addition, each approach has its own terms and principles, some of which will be mentioned briefly in the following summaries of the three approaches. All of them will be explained fully in later units.

Sales Comparison Approach

The **sales comparison approach**, or market data approach, to appraising makes the most direct use of the principle of substitution. The value of a property is considered to be related to the selling prices of properties like it. In the sales comparison approach, then, an opinion of value is obtained by comparing the property being appraised—the subject property—to recent sales of similar, nearby properties, called *comparables* or *comps*. The appraiser finds three to five (or more) comps.[1] The appraiser notes any dissimilar features between the subject property and each of the comps and makes an adjustment for each difference by using the following formula:

$$\begin{array}{c}\text{Sales price of}\\ \text{comparable property}\end{array} \pm \text{Adjustments} = \begin{array}{c}\text{Indicated value}\\ \text{of subject property}\end{array}$$

The appraiser adds to the sales price of a comparable property the value of a feature present in the subject property but not in the comparable. The appraiser subtracts from the sales price of the comparable property the value of a feature present in the comparable but not in the subject property. Major types of adjustments include those made for physical (on-site) features, locational (off-site) influences, conditions of sale (buyer-seller motivation and financing terms), and time from date of sale. After going through this process for each of the comparable properties, the appraiser assigns a value to the subject property that is the adjusted sales price of the comparable(s) most like the subject.

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1. The number of sales needed for an accurate estimate of value cannot be easily specified. Most appraisers believe that three to five comparable sales constitute a representative sample—particularly if the sales are very similar, are located close by, and have sold recently. The fewer the sales, the more carefully they should be investigated. If the quality of the data collected is questionable, a larger number of sales should be considered.

   The reason for an appraisal can also influence the number of comparable sales needed. For example, an appraisal used to establish value in a condemnation proceeding would probably require a greater number of comparable sales than one used to establish value for a mortgage loan.

IN PRACTICE

House A, which sold for $355,000, is comparable to house B, the subject property, but has a garage valued at $25,000. House B has no garage. In this case, using the formula for the sales comparison approach, the market value of the subject property would be reached as shown below.

$$\$355{,}000 - \$25{,}000 = \$330{,}000$$

House B is valued at $330,000.

IN PRACTICE

House X, the subject property, is 15 years old. A comparable property, house Y, is 15 years old and sold for $270,000 one year prior to this appraisal. Because of changes in market conditions since the sale of house Y, the appraiser has determined that 10% added to the sales price is an accurate reflection of the increase in property values over the year. In this case, using the formula for the sales comparison approach:

$$\$270{,}000 + (10\% \times \$270{,}000) = \text{Value of subject property}$$
$$\$270{,}000 + \$27{,}000 = \$297{,}000$$

House X is valued at $297,000.

Vacant land is valued in the same way, by finding other comparable properties and adding or subtracting, as necessary, the worth of any amenities present in either the subject or the comparable property and not in the other. Features of vacant land requiring a sales price adjustment might include installation of utilities, composition of soil, terrain, size, shape, zoning, and location. Factors requiring a major sales price adjustment for land zoned for residential use could include location in a flood plain; proximity to undesirable land uses, such as a landfill or industrial area; or high building permit and construction costs in a congested urban or suburban area.

Cost Approach

In the **cost approach**, the appraiser estimates the value of any improvements to the land (such as structures) in terms of their reproduction or replacement cost as though new. The distinction between reproduction and replacement cost is discussed in Unit 10. The appraiser then subtracts any loss in value owing to the depreciation of the improvements. Finally, the appraiser adds an estimate of the value of the site itself, usually found by the sales comparison approach. The rationale of the cost approach is that a knowledgeable buyer will pay no more for a house than the cost of constructing a substitute house on a similar lot and with similar design and amenities. The formula for the cost approach is

$$\text{Reproduction or replacement cost of improvements} - \text{Depreciation on improvement(s)} + \text{Site value} = \text{Property value}$$

Depreciation may occur through either deterioration (effects of wear and tear or the elements) or obsolescence. Obsolescence can be functional, such as outmoded room layout or design, or external, caused by changes in factors outside the property, such as zoning, the property's highest and best use, or supply and demand.

IN PRACTICE

A house being appraised is similar in size, design, and quality of construction to a new house that has a construction cost of $225,000. The house being appraised has depreciated by 20% due to lack of maintenance and is on a lot valued separately at $40,000. Using the cost approach formula:

$$\$225{,}000 - (20\% \times \$225{,}000) + \$40{,}000 = \text{Property value}$$
$$\$225{,}000 - \$45{,}000 + \$40{,}000 = \$220{,}000$$

The value of the property based on the cost approach is $220,000.

IN PRACTICE

A warehouse that would cost $850,000 to construct today has depreciated 25% in its lifetime and is on land valued at $440,000. What is the property's total estimated value by the cost approach?

$$\$850{,}000 - (25\% \times \$850{,}000) + \$440{,}000 = \text{Property value}$$
$$\$850{,}000 - \$212{,}500 + \$440{,}000 = \$1{,}077{,}500$$

The value of the property based on the cost approach is $1,077,500.

Income Capitalization Approach

The **income capitalization approach** is based on the net income, or investment return, that a buyer expects from the property. The price that the buyer will pay will be determined by the probable return the property will yield from the investment. The income capitalization approach is used primarily for valuing income-producing properties such as apartment buildings, shopping centers, and office buildings.

Remember that the income capitalization approach is based on net operating income—which is usually expressed as an annual amount. Rents are not net operating income. All the expenses of maintaining the building, such as upkeep and management, must be subtracted from effective gross income (scheduled rents plus any other income minus vacancy and collection losses) to realize net operating income.

If a property's net operating income for the year is known, as well as the buyer's anticipated overall rate of return for the investment (stated as a capitalization or "cap" rate), value can be computed by using the following formula:

$$\text{Net operating income} \div \text{Return (capitalization rate)} = \text{Property value}$$

Or:

$$\frac{I}{R} = V$$

The cap rate increases as the risk to the investor increases. The higher the cap rate, the lower the property value, and the lower the cap rate, the higher the property value.

IN PRACTICE

A buyer wants a 6% investment return. He is interested in a medical office building that produces a net operating income of $425,000 per year. What would the buyer be willing to pay for the building?

$$\frac{\$425{,}000}{0.06} = \$7{,}083{,}333$$

The property value that will produce the expected net operating income is $7,083,333.

The return that can be expected based on an estimated level of income and property value can be computed by using a variation of the basic income capitalization formula:

$$\frac{\text{Income}}{\text{Property value}} = \text{Return}$$

Or:

$$\frac{I}{V} = R$$

IN PRACTICE

An investor estimates that a net operating income of $39,300 can be received from a building that will require an investment of $560,000. What is the investor's capitalization rate (return)?

$$\frac{\$39{,}300}{\$560{,}000} = 0.07017$$

The expected return, based on the income alone, is 7%.

A buyer who has only a certain amount to invest and wants a specific rate of return from his investment would use another variation of the formula:

$$\text{Property value} \times \text{Return} = \text{Net operating income}$$

Or:

$$V \times R = I$$

IN PRACTICE

To receive an 8% return from an investment of $700,000, what would be the required net operating income of the purchased property?

$$\$700,000 \times 0.08 = \$56,000$$

The net operating income would have to be $56,000.

Exercise 6-1

Using the formula for the approach specified, solve each of the following appraisal problems.

Sales comparison approach:

House X, in an Arizona community in which swimming pools are highly desired, is being appraised. It is very similar to house Y, but house Y has an in-ground swimming pool and spa valued at $27,000. House Y sold two months ago for $778,000. What is the market value of house X using the formula for the sales comparison approach?

Cost approach:

A retail store, built 15 years ago, has depreciated about 30% overall. It would cost $230,000 to build today, and similar sites are now worth $52,000. What is the market value of this store using the formula for the cost approach?

Income capitalization approach:

An apartment building provides a net annual operating income of $64,500. Investors are expecting a 9% return on this type of investment. What will the asking price be if it is the same as the market value found by the formula for the income capitalization approach?

Check your answers against those in the answer key at the back of the book.

■ RELATIONSHIP OF APPROACHES

The three approaches to real estate appraisal require different kinds of information, which may include data on comparable nearby property sales (sales comparison approach), building cost (cost approach), and investment return (income capitalization approach). The information available will help determine which appraisal method will be given the most validity in the appraiser's opinion of the market value of the subject property.

As a general rule, the sales comparison approach is the most reliable approach with single-family residences; the cost approach is most reliable with non-income-producing properties having a limited market or with special purpose properties; and the income capitalization approach is most reliable with income-producing properties.

Most appraisals will require the use of more than one approach, especially when land value must be distinguished from building value. This is true when the cost approach is used to find building value. There are other instances when land value must be separated from building value, such as for tax valuation purposes. These will be discussed later in this book.

IN PRACTICE

If a 45-year-old school building is to be sold, what approach would be given the most weight in determining its market value?

School buildings are not usually on the market, so there probably would be no recent comparable sales in the vicinity. If the building could be used as office or other rental space as it stood, or with a little remodeling, the income capitalization approach might be feasible. The approach given the most weight, however, would probably be the cost approach, because the high cost of constructing a similar new building would probably be the most significant selling factor.

The next step in the appraisal process is to analyze the value indications from the three approaches to arrive at the best and most supportable opinion of value. This can be either a single dollar figure or a range into which the value most likely will fall. The process the appraiser follows to do this is called reconciliation.

Proper analysis and reconciliation are essential to a good appraisal report. The use of accepted appraisal methods does not in itself produce a sound opinion of value. It must be combined with good judgment on the part of the appraiser, as well as experience in gathering needed information and making thorough analyses and valid interpretations of relevant data.

The reconciliation process is covered in detail in Unit 15, "Reconciliation and the Appraisal Report."

Exercise 6-2

Decide which appraisal approach(es) would normally carry the most weight in valuing each of the following properties:

1. A factory
2. An automobile showroom and garage
3. A public building formerly used as a town hall
4. Farmland surrounded by commercial and industrial developments
5. A one-story retail store in a busy downtown business district
6. An older, single-family residence in a neighborhood rezoned to permit high-rise apartments
7. A medical office building in a business center adjacent to a hospital complex
8. A single-family, owner-occupied residence

9. A place of worship
10. A small abandoned roadside restaurant adjacent to a new apartment complex

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Check your answers against those in the answer key at the back of the book.

■ SUMMARY

The appraisal process begins with a statement of the problem—the purpose of the appraisal—which will help determine the scope of work required to complete the appraisal assignment. The interest to be appraised, whether a fee simple estate, life estate, leasehold estate, leased fee estate, or some other property interest, must be noted, as well as the client and the reason for the appraisal. By gathering, recording, verifying, and analyzing all the necessary data, the appraiser can form an opinion of value based on knowledge and understanding and not guesswork.

There are three basic approaches to determining the market value of real property. The sales comparison approach makes use of data regarding recently sold properties that are similar to the subject property. The cost approach utilizes the present construction cost of existing improvements less depreciation. The income capitalization approach makes use of the net operating income that may be expected from the property. The appraiser must use the appraisal approaches that are most reasonable in light of the type of property being appraised.

■ Review Questions

1. The appraisal approach that would be *MOST* useful in valuing single-family residential property is
   a. the sales comparison approach.
   b. the cost approach.
   c. the income capitalization approach.

2. The appraisal approach that normally would be *MOST* useful in valuing investment property is
   a. the sales comparison approach.
   b. the cost approach.
   c. the income capitalization approach.

3. The appraisal approach that normally would be *MOST* useful in valuing public and religious-use properties is
   a. the sales comparison approach.
   b. the cost approach.
   c. the income capitalization approach.

4. The reliability of an appraisal depends on
   a. the knowledge and judgment of the appraiser.
   b. the accuracy of the data used.
   c. both of these.
   d. neither of these.

5. Property A is a single-family residence that sold for $480,000. It is very similar to property B, which you are appraising, except that property A has a two-car garage worth $36,000. Using the formula for the sales comparison approach, calculate the market value of property B.

6. An office building has depreciated 40% since it was built 25 years ago. If it would cost $725,000 to build today, and if similar sites are selling for $175,000, what is the market value of the property using the formula for the cost approach?

7. You are appraising a single-story building producing net operating income of $124,000 per year. If you determine that a 9% return is justified on this investment, what would be your value estimate of the property using the income capitalization approach formula?

8. The appraisal process provides all of the following advantages, *EXCEPT*
   a. increases efficiency.
   b. reduces liability.
   c. increases fees.
   d. assists enforcement agencies.

9. The first step in the appraisal process is to
   a. define the problem.
   b. collect the fee.
   c. collect data about the subject property.
   d. reconcile the values reached by each of the appraisal approaches.

10. The last step in the appraisal process is to
    a. state the problem.
    b. report opinion of value.
    c. reconcile the values reached by each of the appraisal approaches.
    d. collect the fee.

11. The step in the appraisal process that determines what the appraiser should do in an assignment is
    a. define the problem.
    b. gather data.
    c. determine the scope of work.
    d. talk to the client.

12. The date of an appraisal is determined by
    a. the lender.
    b. the client only.
    c. the party who pays the appraiser.
    d. the conversation between the client and the appraiser.

13. The date of the appraisal is also known as
    a. the effective date.
    b. the inspection date.
    c. the calendar date.
    d. the date of the report.

14. Limiting conditions in an appraisal report serve to
    a. limit the client's responsibilities.
    b. limit the appraiser's responsibilities.
    c. protect the public.
    d. limit the appraiser's license.

15. The date of the appraisal can be
    a. any date chosen by the appraiser.
    b. any date chosen by the client.
    c. any date chosen by an agreement between client and appraiser, but can only be a present date.
    d. any date chosen by an agreement between client and appraiser, and can be a past, present, or future date.

16. FNMA and FHLMC are part of
    a. the primary mortgage market.
    b. the secondary mortgage market.
    c. the Federal Housing Administration.
    d. the Federal Reserve System.

17. The three approaches to value are used
    a. on every assignment.
    b. as appropriate, according to the scope of work.
    c. according to the client's instruction.
    d. to increase the appraisal fee.

18. If the NOI stays the same and the cap rate increases, property value
    a. decreases.
    b. increases.
    c. stays the same.
    d. cannot be determined.

19. If the NOI stays the same and the property value increases, the cap rate
    a. decreases.
    b. increases.
    c. stays the same.
    d. cannot be determined.

20. The form used most often for FNMA appraisals is
    a. the VA.
    b. the FHA.
    c. the URAR.
    d. the narrative.

Check your answers against those in the answer key at the back of the book.