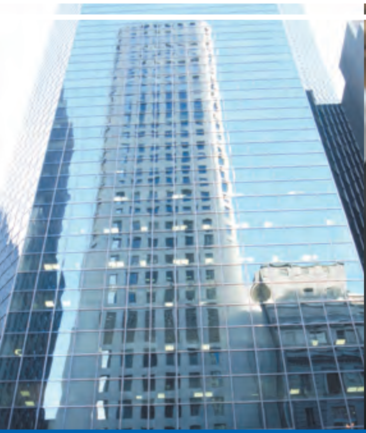
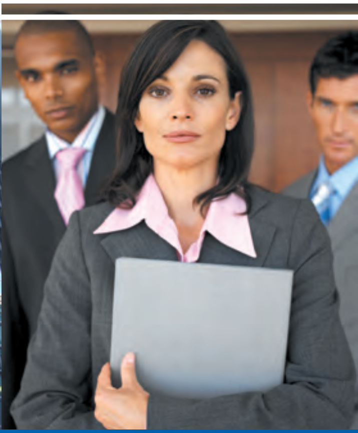
Appraisal Institute®

Professionals Providing Real Estate Solutions

Understanding the Appraisal





Understanding The Appraisal

Much of the private, corporate and public wealth of the world consists of real estate. The magnitude of this fundamental resource creates a need for informed appraisals to support decisions pertaining to the use and disposition of real estate and the rights inherent in ownership. An appraisal answers one or more specific questions about a real estate parcel's value, marketability, usefulness or suitability.

The Appraisal Defined

Professional real estate appraisers perform a useful function in society and offer a variety of services to their clients. They develop opinions of several types of property value and assist in various decisions about real estate. Standards for the appraisal profession are set forth in the Uniform Standards of Professional Appraisal Practice (USPAP) developed by the Appraisal Standards Board of The Appraisal Foundation.* USPAP specifies the procedures to be followed in developing and communicating an appraisal and the ethical rules for appraisal practice. As defined in USPAP, an appraisal is the act or process of developing an opinion of value. The valuation process is a systematic procedure the appraiser follows to answer a client's question about real property value.

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*www.appraisalfoundation.org

The most common type of appraisal assignment is the development of an opinion of market value. However, because of their specialized training and experience, appraisers can provide a wide range of additional appraisal services–from investment consultation to advice on various business as well as personal financial decisions.

The Intended Use of an Appraisal

An appraisal may be requested or required for many reasons.

- To facilitate the transfer of ownership of real property
- To help prospective sellers determine acceptable selling prices or prospective buyers decide on offering prices
- To establish a basis for the exchange or reorganization of real property or for merging the ownership of multiple properties

Many appraisal assignments relate to financing and credit.

- To assist the underwriter in establishing a value of security for a mortgage loan
- To provide an investor with a sound basis for the purchase of real estate mortgages, bonds or other types of securities

Other appraisals are requested to help resolve legal or tax issues.

- To estimate the market value of a property in eminent domain proceedings
- To estimate the market value of a property in contract disputes or as part of a portfolio

- To estimate the market value of partnership interests
- To estimate damages created by environmental contamination
- To estimate assessed value
- To determine gift or inheritance taxes
- To estimate the value of the real property component of an estate

Appraisals are also used in investment counseling and decision-making.

- To set rent schedules and lease provisions
- To determine the feasibility of a construction or renovation program
- To aid in corporate mergers, issuance of stock or revision of book value
- To estimate liquidation value for forced-sale or auction proceedings
- To counsel a client on investment matters, including goals, alternatives, resources, constraints and timing
- To advise zoning boards, courts and planners, among others, regarding the probable effects of proposed actions
- To arbitrate between adversaries

Appraisals for the Lending Industry

Many appraisals are performed for lending purposes. Property owners should be aware that current federal lending regulations* require the lender to "initiate" the appraisal. The lender must have the first contact with the appraiser and oversee the appraisal process. According to these

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*Interagency Appraisal and Evaluation Guidelines, October 27, 1994, and Independent Appraisal and Evaluation Functions, October 27, 2003 http://www.fdic.gov/news/news/financial/2003/fil0384b.html; http://www.fdic.gov/news/news/financial/2003/fil0384a.html.

regulations, the lender must be the client, and the appraiser must be engaged by the lending institution. Any property owner who wants to use the appraisal for lending purposes should communicate this need to the lender and have the lender engage the appraiser. This avoids the possibility of the lender rejecting the appraisal or requiring a new appraisal because the appraisal was not initiated by the bank. According to the federal lending laws, any bank can use an appraisal prepared for another bank, as long as the initiating bank reviews the appraisal and finds it to be acceptable.

Value Influences

The analysis of social, economic, governmental and environmental forces provides an understanding of the dynamics of change and helps identify value trends. Against this background, the appraiser investigates the characteristics of the subject property that might impact the property's value. The appraiser also investigates the nature of the market for that property, competitive properties, and the buyers and sellers who constitute the market for that property type. The principles of supply and demand, substitution, balance and externalities help explain shifts in value.

Four independent economic factors–utility, scarcity, desire, and effective purchasing power–must be present to create value in a particular item or collection of items. Professional appraisal standards specifically require the study of all value influences. Change and anticipation are fundamental in this analysis, and appraisers apply these principles and related concepts that influence value in their analysis.

Approaches to Value

Participants in the real estate market commonly think of value in three ways:

- The current cost of reproducing or replacing a building, minus an estimate for depreciation, plus the value of the land (and entrepreneurial incentive, if applicable)
- The value indicated by recent sales of comparable properties in the market
- The value that the property's net earning power will support

These different viewpoints form the basis of the three approaches that appraisers use to value property–the cost, sales comparison and income capitalization approaches. One or more of these approaches may not be applicable to a given assignment or may be less significant because of the nature of the property, the appraisal problem or the data available. The approaches to value are applied within the context of the valuation process.

The Valuation Process

Although characteristics of properties differ widely, all appraisal problems can be solved through the systematic application of the valuation process. In the valuation process the problem is defined, the work necessary to solve the problem is planned and relevant data are collected, verified and analyzed to form an opinion of value.

Definition of the Problem

- Identification of client/ intended users
- Intended use of appraisal
- Type and definition of value
- Date of opinion of value
- Identification of characteristics of property (including location and property rights to be valued)
- Extraordinary assumptions
- Hypothetical conditions

Scope of Work

Data Collection and Property Description

Market Area Data
General characteristics of region, city, and neighborhood

Subject Property Data
Specific characteristics of land and improvements, personal property, business assets, etc.

Comparable Property Data
Sales, listings, offerings, vacancies, cost and depreciation, income and expenses, capitalization rates, etc.

Data Analysis

Market Analysis
Demand studies
Supply studies
Marketability studies

Highest and Best Use Analysis
Site as though vacant
Ideal improvement
Property as improved

Land Value Opinion

Application of the Approaches to Value

Cost
Sales comparison
Income capitalization

Reconciliation of Value Indications and Final Opinion of Value

Report of Defined Value

The valuation process is accomplished by following specific steps, the number of which depends on the nature of the appraisal assignment and the data available to complete it. In all cases, however, the valuation process provides the model to be followed in performing market research and data analysis, in applying appraisal techniques and in integrating the results of these analytic activities into an opinion of value.

Definition of the Problem

The first step in the valuation process is to develop a concise statement of the problem. This sets the parameters of the assignment and eliminates any ambiguity about the nature of the assignment. In this step the appraiser identifies the client or intended user of the appraisal, the real estate to be appraised, the intended use of the appraisal, the type and definition of value, the date of the value opinion, the property characteristics (including location and property rights to be valued) and any extraordinary assumptions or hypothetical conditions affecting the assignment.

Scope of Work

The scope of work is the amount and type of information researched and the analysis applied in an assignment. After the problem to be solved is clearly defined, the appraiser must next determine the appropriate scope of work to solve the problem. The scope of work must be clearly disclosed in the appraisal report.

Data Collection and Property Description

In this step the appraiser gathers general data on the market area and specific data on the subject and comparable properties. The appraiser collects general data related to property values in an area to understand the economic climate in which property competes and the interacting forces that cause values to increase, decrease or remain stable. Specific data are details about the property being appraised (the subject property) and comparable properties that have been sold or leased in the local market. Land and building descriptions are specific data that help an appraiser to select comparable sales and rentals.

Data Analysis

In the analysis of general data, national, regional and local trends are emphasized. Supply and demand data are studied to understand the competitive position of the property in its market. In an analysis of specific data, a set of properties most like the subject property is studied. The analysis of comparable properties helps an appraiser extract specific sale prices, rental terms, incomes and expenses, rates of return on investments, construction costs, economic life estimates and rates of depreciation. These figures are used in the calculations that result in indications of value for the subject property.

Highest and best use is a critical step in the development of a market value opinion. In highest and best use analysis, the appraiser considers the use of the land as though it were vacant and the use of the property as it is improved. To qualify as the highest and best use, a use must satisfy four criteria:

it must be legally permissible, physically possible, financially feasible and maximally productive.

The highest and best use is selected from various alternative uses. Market analysis provides the basis for an appraiser's conclusions about the highest and best use of a subject property, and the remainder of the valuation process follows from these conclusions.

Land Value Opinion

A land value opinion is formed through the application of a variety of methods that are derived in varying degrees from the three approaches to value. The most reliable procedure for arriving at a land value estimate is sales comparison. Sales of similar vacant parcels are analyzed, compared and related to the land being appraised.

If sufficient sales are not available for comparison or the value opinion indicated by sales comparison needs substantiation, the appraiser may use another procedure such as extraction, allocation, the land residual technique, ground rent capitalization, or subdivision development analysis.

Application of the Approaches to Value

The appraiser begins to derive an opinion of property value using one or more of the three approaches to value. The approaches employed depend on the type of property, the use of the appraisal and the quality and quantity of the data available for analysis.

Cost Approach

The cost approach is based on the understanding that market participants relate value to cost. In the cost approach, the value of a property is derived by adding the estimated value of the land to the current cost of constructing a reproduction or replacement for the improvements and then subtracting the amount of depreciation in the structures from all causes. Entrepreneurial profit and/or incentive may be included in the value indication.

The current cost to construct the improvements can be obtained from cost estimators, cost manuals, builders and contractors. Depreciation is of three different types (physical deterioration, functional obsolescence and external obsolescence) and is measured through market research and the application of specific procedures. Land value is estimated separately in the cost approach.

This approach is particularly useful in valuing new or nearly new improvements and properties that are not frequently exchanged in the market. Cost approach techniques can also be employed to derive information needed in the sales comparison and income capitalization approaches to value, such as an adjustment for the cost to cure items of deferred maintenance.

Sales Comparison Approach

The sales comparison approach is most useful when a number of similar properties have recently been sold or are currently for sale in the subject property's market. Using this approach, an appraiser develops a value indication by comparing the subject property with similar properties, called comparable sales. The sale prices of the properties that are judged to be most comparable tend to indicate a range in which the value indication for the subject property will fall.

The appraiser estimates the degree of similarity or difference between the subject property and the comparable sales by considering various elements of comparison:

- Real property rights conveyed
- Financing terms
- Conditions of sale
- Expenditures made immediately after purchase
- Market conditions
- Location
- Physical characteristics
- Economic characteristics
- Use/zoning
- Non-realty components of value

Dollar or percentage adjustments may be applied to the known sale price of each comparable property to derive a range of value indications for the subject property. Through this comparative procedure, the appraiser ultimately arrives at an opinion of value.

Income multipliers and capitalization rates may also be extracted through analysis of comparable sales, though these factors are not regarded as elements of comparison in the sales comparison approach. Instead, they are usually applied in the income capitalization approach.

Income Capitalization Approach

Income-producing real estate is typically purchased as an investment, and from an investor's point of view earning power is the critical element affecting property value. In the income capitalization approach, value is measured as the present value of the future benefits of property ownership. There are two methods of income capitalization: direct capitalization and yield capitalization. In direct capitalization, the relationship between one year's income and value is reflected in either a capitalization rate or an income multiplier. In yield capitalization, the relationship between several years' stabilized income and a reversionary value at the end of a designated period is reflected in a yield rate. The most common application of yield capitalization is discounted cash flow analysis. Given the significant differences in how and when properties generate income, there are many variations in both direct and yield capitalization procedures.

The specific data that an appraiser investigates in the income capitalization approach might include the property's gross income expectancy (assuming either market rent or contract rent), the expected reduction in gross income caused by vacancy and collection loss, the anticipated annual operating expenses, the pattern and duration of the property's income stream and the anticipated reversionary value. After income and expenses are estimated, the income streams are capitalized by applying an appropriate rate or factor or converted into present value through discounting. In discounted cash flow analysis, the quantity, variability, timing and duration of a set of periodic incomes and the quantity and timing of the reversion are specified and discounted to a present value at a specified yield rate. The rates used for capitalization or discounting are derived from acceptable rates of return for similar properties.

Reconciliation of Value Indications and Final Opinion of Value

In reconciliation the appraiser analyzes alternative conclusions and selects a final opinion of value from among two or more indications of value. A thorough review of the entire valuation process may precede reconciliation.

In reconciliation an appraiser draws upon his or her experience, expertise and professional judgment to resolve differences among the value indications derived from the application of the approaches. The appraiser weighs the relative significance, applicability and defensibility of each approach and relies most heavily on those most appropriate to the intended use of the appraisal. The conclusion drawn is based on the appropriateness, accuracy and quantity of all the evidence in the appraisal.

When a final opinion of value has been derived, the immediate objective of the valuation process has been accomplished. However, an appraisal assignment is not completed until the conclusions and findings have been stated in a report and communicated to the client.

Report of Defined Value

The type, format, length and contents of a written appraisal report may vary depending on the requirements of the client and the scope of work criteria. The Uniform Standards of Professional Appraisal Practice set forth the requirements for appraisal reports, which may be presented in one of three written formats: self-contained reports, summary reports, and restricted-use reports. In general, a self-contained report fully describes the data and analyses used in the assignment.

It provides comprehensive coverage of appropriate information contained within the report itself with minimal reference to files outside the report. A summary appraisal report summarizes the data and analyses used in the assignment. A restricted-use appraisal report simply states the conclusions of the appraisal; it may be provided only when the client is the sole user of the report. The appraisal file for a summary or restricted-use appraisal report contains backup data and/or analyses that would be presented in a self-contained appraisal report. A form report may be a summary or a restricted-use report. An appraisal may also be communicated by means of an oral report when circumstances do not permit or warrant the preparation of a written report.

Certification

The certification states that the appraiser has personally conducted the appraisal in an unbiased, objective manner in accordance with USPAP. It may follow the final opinion of value or be combined with it. The certification must be signed by the appraiser. Certification is important because it clearly states the role of the appraiser, thereby clarifying that the assignment was performed by an individual who is impartial, objective and unbiased.

All appraisal reports will specify the following items:

- the identity of the client and any other intended users
- the intended use of the report
- the type and definition of the value to be estimated
- the effective date of the appraisal

- the real estate being appraised
- the real property interest being valued
- any extraordinary assumptions and hypothetical conditions affecting the appraisal
- the scope of work–i.e., the extent of the process of collecting, confirming and reporting data
- any usual valuation approaches that may have been excluded
- the highest and best use of the real estate when such an opinion in necessary and appropriate
- the information considered, appraisal procedures followed and reasoning applied
- a signed certification in accordance with USPAP Standards Rule 2-3.

For More Information on Real Estate Appraisal

The Appraisal Institute's classic textbook, *The Appraisal of Real Estate*, provides a solid foundation on which to build a broad and substantial understanding of real property valuation. For half a century, generations of real estate professionals have relied on *The Appraisal of Real Estate*. No other book serves as a complete resource and a reliable guide through the complex, evolving discipline of real property valuation.

The Appraisal of Real Estate, 12th edition (2001)
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How to Find a Qualified Appraiser

In every field of business and professional endeavor, there are experts who are recognized for their skill and superior abilities. In the real estate appraisal profession, these are generally appraisers who have extensive training and experience, subscribe to a code of professional ethics and standards of professional practice and have received professional recognition for their abilities. Designated members of the Appraisal Institute, holding the MAI, SRPA or SRA designation, are such appraisers.

Appraisal Institute professional membership designations are conferred on individuals who have met stringent education requirements, above and beyond minimal state licensing requirements, and have demonstrated appraisal experience. Currently, the Appraisal Institute confers one general designation, the MAI, and one residential designation, the SRA. Once designated, these members participate in a program of continuing education. Training in up-to-date valuation techniques, coupled with experience and integrity, make Appraisal Institute designated members the preferred source of high-quality appraisal services. Designated members of the Appraisal Institute can guide and support decisions to invest in, buy or sell property and answer questions about a property's value, quality, suitability and feasibility for various uses.

Consult the Appraisal Institute's Web site directory at *www.appraisalinstitute.org/search.asp*. This online directory lists thousands of designated and associate members of the Appraisal Institute throughout the United States and abroad. For more information about Appraisal Institute education programs, publications and other services and benefits, e-mail info@appraisalinstitute.org.

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Today and throughout its 70-year history, the Appraisal Institute is the leading organization for professional real estate appraisers. Through its extensive educational programs, the Appraisal Institute's more than 18,000 members are skilled in the up-to-date methods of real estate valuation for commercial and/or residential properties. Reflecting their unbiased and objective approach to real property appraisal and analysis, members of the Appraisal Institute adhere to a strictly enforced Code of Professional Ethics and Standards of Professional Appraisal Practice. Appraisal Institute members may hold the prestigious MAI, SRPA and SRA designations.

The Appraisal Institute advocates equal opportunity and nondiscrimination in the appraisal profession and conducts its activities in accordance with applicable federal, state, and local laws.