Appraising is far from an exact science, but a degree of relative uniformity may be achieved by applying proven appraisal techniques along with the use of factual information. Many professional appraisers concentrate all their time on the profession and are recognized for their knowledge, skill, and experience in the field. They interpret the facts in an unbiased manner from pertinent available information. An independent fee appraiser may be called upon to support his opinions in a court of law, so diligent care is taken with each parcel appraised. Although real estate brokers and salespersons need not qualify as professional appraisers, they should be familiar with the three approaches to determining value by means of the appraisal process and should be capable of arriving at the market value of the property they intend to list and market.

This chapter will explore the many purposes for which the fee appraiser may be requested to determine valuation of a property, the steps in an appraisal, and how valuation is arrived at and shown in the written, documented appraisal report furnished to the client. Title XI of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the new regulations placed upon appraisers are addressed in this chapter.
APPRAISALS

An appraisal is simply an estimate of value. It is an opinion as to the worth of a particular piece of property. An appraiser must measure the value of each parcel of real estate appraised and furnish a supportable opinion.

A definite sequence of steps is followed in the appraisal process:

1. Defining the problem: identifying the parcel of real estate by the legal description and street address and stating the purpose of the appraisal
2. Collecting the data
   a. economic
   b. neighborhood
   c. property
3. Analyzing and applying the three approaches
   a. sales comparison
   b. cost
   c. income
4. Correlating the data and analyzing the results
5. Writing the appraisal report

THE PURPOSE OF AN APPRAISAL: DEFINING VALUE

Since value means different things to different people, the purpose of the appraisal is the first question asked by the appraiser. To the owner of the property, value would be considered as market value, investment value, and value in use. The insurance agent will think in terms of insured value, while the lender is concerned with loan value. The appraiser’s report will clearly state the nature of the assignment. Value is defined as the present worth of future benefits that accompany the ownership of real property, and for value to exist there must be benefits. Valuation may be sought to determine any of the following:

1. Market value. The most probable selling price at which a willing seller will sell and a willing buyer will buy, with neither being under abnormal pressure, is commonly referred to as market value. It is the price a property is expected to bring if exposed for sale on the open market, allowing a reasonable amount of time to find a purchaser who is fully aware of the uses to which the property may be put. Keep in mind that value is created by the desire of people for a commodity or a service. Market price is the actual sale price of the property set through bargaining and negotiation. Market price may differ from market value if the seller needs to sell quickly.

2. Loan value. Prior to committing to a loan, a lending institution has an appraiser give a report on the property’s value since it is the collateral for the loan. This constitutes the greatest reason for appraisals in the residential resale and refinance market.

3. Insurance value. The lender requires the borrower to insure the property to protect the lender’s interest. The insurance policy needs to cover the amount of the loan, with the lender named as co-beneficiary. The property owner also wants to insure the investment, regardless of whether a loan is involved. In case of damage or destruction, the owner is assured of sufficient coverage to replace the structure.

4. Estate tax value. The value of a deceased person’s real property needs to be determined for inheritance tax purposes.
5. **Lease interest.** If a commercial property carries a long-term lease, it may contain a reappraisal clause since the leasehold value may change over a period of time. Some properties, such as vacation homes or commercial buildings, are built on leased land, and the land value may vary over the length of the lease. An appraisal would be important to a buyer to determine the lease value of a property in the current market. The leases may be high, but if the leases are due to expire soon, the buyer will want to be assured the leases can be renewed at the present rate.

6. **Tax assessment.** Real property is assessed to establish its **ad valorem tax** value. The county assessor’s office appraises the property, and the assessed value is provided by the law of the municipality. The city council or governing board then sets the mill levy according to the amount of money needed to meet the budget and expenses of the local government. This budget is submitted by the county auditor and approved by the council.

To determine the amount of taxes on a property, the assessed value is multiplied by the mill levy. (A mill equals one-tenth of a cent.) Property may be taxed at its full assessed value or at a percentage of the appraised value as shown in the following example:

\[ \begin{align*}
70,000 & \quad \text{appraised value} \\
.30 & \quad \text{percentage taxed} \\
21,000 & \quad \text{assessed value} \\
.070 & \quad \text{mill levy} \\
1,470 & \quad \text{annual taxes}
\end{align*} \]

Taxes are sometimes expressed in dollars, as $2.00 per $100 of appraised value. Thus, the $70,000 appraised value times $2.00 would equal $1,400 annual taxes.

7. **Eminent domain.** As discussed in Chapter 2, under the right of eminent domain the police power of a governmental body may be invoked to take the property of an individual for public use. The property is condemned, and appraisers determine its fair market value. When a fraction of an individual’s property is condemned and taken (as under the right of eminent domain), the appraiser determines what the value of the property was before that portion was taken and what the remainder is now worth. This **before-and-after method** awards **just compensation** to the condemnee (property owner) for the loss of that portion of land.

8. **Financial statement.** If a person needs to borrow capital, the lender may require a current appraisal of the borrower’s real estate holdings to establish the net equity the property owner has in the property.

9. **Third-party companies.** An appraisal will serve as a basis for corporations or third-party companies that purchase the homes of transferred employees.

10. **Liquidation.** In a forced sale or auction, a liquidation value is needed.

11. **Divorce cases.** An appraisal is necessary to settle disputes over distribution of assets.

At this point the difference between a competitive market analysis (CMA) as discussed in Chapter 7 and a fee appraisal should be clarified. The CMA is different in both purpose and form. The broker and salesperson need to arrive at the probable market value each time they list or sell a property. This is approached by comparing the selling price of similar properties that have recently sold in the same neighborhood or a corresponding area and by checking the listed price of expired listings. Through continuous evaluation of recent sales and expired listings, the broker and salesperson keep abreast of values and the changing market conditions that affect them. However, they are not expected to give written and certified reports such as the fee appraiser prepares. The real estate salesperson’s only concern is pricing and selling the property at a realistic selling price in today’s market.
FORCES AFFECTING VALUE

The appraiser must consider the forces that continually affect value as property values are influenced at national, regional, and the local community levels. The four major forces that have the greatest influence on residential real estate values are as follows:

1. governmental (political) actions
2. economic (financial) forces
3. physical or environmental forces
4. sociological forces

These four forces can modify value, create value, or destroy value.

Governmental (Political) Factors

At the national level the influence of federal control over policies that affect inflation has an impact on the cost of housing. Interest rates are directly responsive to government action, thus determining the number of people who are able to buy real estate.

The political conditions in regional and local governments also affect housing purchases. Property taxes and services rendered by the local governing body affect property values. If taxes are extremely high and services, such as street maintenance and police protection, are not at acceptable standards, people may not want to move into an area or to remain there.

Local government laws and regulations that affect value include an area’s master plan for structured growth, zoning laws, ordinances controlling subdivisions, building codes, environmental regulations, and fire and safety standards.

Economic (Financial) Factors

Regional and local economic conditions are important to the appraiser because they can affect value. For example, an influx of new industry will create additional employment, bringing new families and spurring retail sales. More spendable money in an area means more prosperity. Conversely, if an area loses major employers, the reverse will be true and home values are likely to plummet. A community with diversified employment provides a healthy economic outlook.

The economic prediction for the future, whether the country is booming or is in recession, and how this relates to the local economy can all affect real estate values. During inflationary times property values increase; during a recession, property values fall. Interest rates and the availability of funds for financing also all play a role in determining the value of real estate.

Physical Factors

The most important influences are conditions in the local sector. The environmental or physical conditions that affect property values include elements outside the subject property. Parks, highways, access to interstates, airports, public transportation, available utilities, and shopping centers in the region play a strong role in property values. Because real estate is immobile, it is subjected to external conditions more than any other commodity.

The topography of the land may also be a factor as it can affect construction costs. A favorable climate will draw people to a particular area, thus enhancing value.

The location of a property within a community is the primary physical factor affecting property value. Certain neighborhoods in a given area will be in greater demand and command higher prices. It may be proximity to a school for a young family or access to the interstate for another.


Sociological Factors

Understanding social elements includes evaluating the population trends of the area because, for example, the prevalent age groups determine the types of housing in demand. That is, different age groups are associated with the need for single-family homes, condominiums, apartments, or retirement complexes. Changes in family size and whether the population in the area is declining, remaining stable, or increasing also influence value.

Sociological factors include the attitudes of the people in the community. How people feel toward the local government and their opinion of the community as a desirable place to live also have an impact on value. People’s attitudes concerning education and their desire for advancing the standards of the community show whether an environment is caring and stable. Cultural amenities such as theaters, arts, parks, zoos, and recreational facilities enhance the lives of the area residents.

In the final analysis, value is created when the following are present:

1. Desire: The commodity must be wanted.
2. Utility: This considers the uses to which it can be put.
3. Scarcity: Supply is limited.
4. Effective purchasing power: Money is available to buy it.

Other Factors Affecting Value

Three approaches are used in the appraisal of real property: the cost approach, the sales comparison approach, and the income approach. Before the appraiser begins to analyze each of these approaches to value, certain basic principles that affect the value must be applied. These principles are discussed below.

Highest and Best Use

When we speak of the highest and best use of property, we are referring to the most profitable use to which it can be put. This use must be a reasonable and probable use that will result in the highest value. Briefly, the highest and best use can be defined as the use that, at the time of the appraisal, is most likely to produce the greatest net return on the land and/or building over a given period of time. Net return is the key phrase in this definition. It means whatever is left from gross yield after all costs are met. Sometimes net return takes a form that may not bring the greatest monetary return, for example, land for a children’s zoo, a city park, or a forest preserve that will give enjoyment to thousands every year.

The appraiser must determine the property value at its present use, which may or may not be the highest and best use. If zoning regulations and government controls do not permit a use that conforms to present market standards, the property could not be used to its highest and best potential. If the use can be changed through rezoning, the value would be considered on that basis, less any costs involved in preparing for the rezoned use. For example, an existing building may need to be demolished.

Principle of Substitution

If the property can be substituted for another, its value is set to an extent by the cost of acquiring a like property. The knowledgeable purchaser today will “shop” and compare properties before making a selection. This is the principle of substitution, used in the sales comparison approach to appraising.

Utility Value

The utility value of a property, how it can be used, is also important in determining value. A lovely wooded lot may appear to be a perfect location for a homesite, but
investigation uncovers that it has a ravine running through it, leaving no feasible spot for a building. Zoning laws and restrictive covenants can also affect the use of a property. A location that may seem ideal for a commercial building but which is zoned only for office buildings will be limited to the use designated by the zoning ordinance. Protective covenants in an area may prohibit the building of a two-story house since it would obscure the views of surrounding homeowners. When appraisers place a value on a particular property, they must carefully weigh its utility value.

Functional utility refers to the usability of a building. A contractor may build one house with a highly desirable, very livable floor plan and choose a plan for another house with a poorly arranged interior. The latter may lack good window placement, have a traffic pattern that necessitates walking through the middle of one room to reach another, or lack storage area. As new innovations and more amenities are incorporated into new construction, older houses that do not have these appointments are considered less functional.

Functional utility

Principle of Contribution

The principle of contribution is the principle the appraiser applies to the return on improvements to the property. To improve a property may not necessarily mean that the total cost of the improvement can be added to the value of the property. While a recreation room will expand the living space of the home and make it more desirable to a buyer, the owner may not recapture the entire cost of the remodeling. Enclosing porches and updating kitchens and baths may add appeal to the property but may not return the seller's total costs.

Principle of Change

Principles of change acknowledge that the life cycle of a building dictates change, for as a neighborhood ages, new land uses may be introduced. Multifamily units may begin to emerge in once affluent neighborhoods as covenants expire and new uses develop through zoning changes. As new styles and plans are built in the suburbs, people on a higher economic scale move beyond the city’s urban area. A great thrust in many cities has been to revitalize the older sectors in an effort to slow suburban sprawl and prevent the decay of the inner city areas.

Changes in a neighborhood may transpire slowly, but the appraiser is trained to detect the implied as well as the evident indications that result in changing conditions. As the area ages, change may occur not only in zoning regulations but also in the income level and average age of the residents. As buyers’ needs and desires change, the forces of change also affect neighborhoods and cities.

New styles in home designs with the use of large expanses of well-designed windows, automated kitchens, and palatial baths appeal to still other buyers. Amenities are the extras that come with ownership. A desirable view, a wooded lot, or the privacy or location of a particular property all can be considered amenities. The amenities desired may vary with different buyers. The proximity to transportation, a shopping center, or schools may be prime considerations for one purchaser, while special energy-conserving features may be most important to another.

Scarcity

The supply will dictate the value; if property is not in demand, the value will decrease. If there is an abundant supply and the need is not there, the value will decrease. Viewing the earth from an airplane, one sees a great amount of vacant land. The problem lies in where the land is. Because of its immobility, we cannot move it closer to where the need for housing and industry is. In heavily populated areas, land is indeed scarce.
Principle of Supply and Demand

The law of supply and demand holds true in real estate as in any other commodity. If consumers have a need and a desire, the result will be value in the product. If 20 houses are built in a new subdivision, but demand is not present, the contractor will have an excess of 20 houses unless the price is lowered to encourage buyers. Conversely, if there is a demand for housing and few are available, prices will rise. The investor must determine the prospects for future growth or decline.

Transferability

Good title that can be transferred with comparable ease is important to value. While this is a legal concept and not an economic factor, value will not exist if the property cannot be transferred. Regardless of the demand, title must be capable of being transferred or its worth is diminished.

Principle of Anticipation

Value is created by anticipating the use or income that will be derived from the property in the future. The homeowner sees value in the property based on the amenities it offers, its ability to meet the buyer’s needs, and consequently its present worth, while the investor will view it from the potential net income to be received from the investment. The anticipated future development of an area is always considered. Schools, highways, and shopping malls are built because of need and demand, thus indicating an increase in value.

Principle of Regression and Progression

If a property has been overimproved, the value of the overimprovement is decreased and the principle of regression applies. To add a $40,000 family room on a house in an area where surrounding homes are being appraised for $60,000 would not result in adding $40,000 to the market value of the overimproved property. This property will fall towards the level of surrounding homes and thus regress.

If a particular property is underimproved and in an area of more expensive homes, the principle of progression applies; despite the underimprovement, the value of the subject property is likely increased.

Principle of Conformity

When a neighborhood is homogeneous, that is, the homes have a relative degree of uniformity, values tend to be higher. If the construction is architecturally compatible and an overall appearance of conformity is adhered to, values will be stabilized in the area. This is one of the reasons for covenants and restrictions in the platting of subdivisions; the property owners are assured that their investment will be secure from that standpoint.

Plotlage Value

The combining of two or more parcels is called assemblage. The increase in the value of the new parcel is referred to as plottage. For example, if zoning laws permit a 6-unit building on a lot that has 15,000 square feet, the acquisition of the adjacent lot of equal size would permit the owner to build a 12-unit building. If a value of $15,000 is placed on each unit, the value has increased from a total of $90,000 ($15,000 × 6 units) to $180,000 ($15,000 × 12 units).
COLLECTING THE DATA

The appraiser maintains a database of information as a ready resource. General data on the region, the city, and the neighborhood are collected and maintained in the database. Regional and city information includes knowledge of the economic conditions of the area. The neighborhood data covers information on areas within certain street boundaries where the houses are of comparable price range and age. The average income and age of the residents and convenience to shopping, public transportation, churches, and schools are other factors considered.

After assembling the regional, city, and neighborhood data, the appraiser begins analyzing the property itself:

1. The site is evaluated; the lot size and street frontage are determined.
2. The square footage of the house is measured.
3. The condition of the house and any extra features it has are noted.
4. Any special assessments against the property are recorded in the report. A special assessment is a charge against real estate to pay for the cost of a public improvement to the property. This assessment is made by a unit of government. Special assessments are levied for the cost of street paving, curbing, sidewalks, and sewers.

APPROACHES TO APPRAISAL

The following are three approaches to assessing property value:

1. The sales comparison approach compares the subject property (the property being appraised) to similar properties that have recently sold, adjusting for the differences.
2. The cost approach considers today’s cost to rebuild and adds the land value.
3. The income approach capitalizes the income, converting future income to present value.

The appraiser makes the decision as to which approach best typifies the subject property. Little credence is given to the income approach when appraising single-family residences, since few are purchased for rental purposes. For these appraisals, greater reliance is placed on the cost and comparison approaches. Conversely, these approaches to value would not be given as much weight in appraising an income-producing property. When appraising a single-purpose building, such as a church, the cost approach would be most applicable since comparable properties would be difficult to locate and the church is not considered income producing.

Sales Comparison Approach

The sales comparison approach is often referred to as the market data approach to value because the subject property (the property being appraised) is compared with properties recently sold in the same general area or in neighborhoods of similar characteristics.

The appraiser will seek comparable properties that have recently sold. Properties currently on the market for sale are not considered since no agreed-upon contract between buyer and seller exists. A minimum of three comparables provides the appraiser with the data necessary to form an opinion as to the value of the subject property. The more similar the properties, the easier it is to conclude value. Allowances and adjustments are made for any differences in the properties. The sales comparison approach to value is the most commonly used method in appraising residential property as it depends on what similar properties are actually selling for.
When locating comparables, the appraiser will first look for recently sold properties in the immediate location of the subject property. If no recent sales are available in the neighborhood, an area similar in value should be searched. It is important that the comparables have sold recently; this is especially true if the market is volatile. Depending on local conditions, adjustments for time lapsed are made either upward or down. It is necessary to locate the same style of house; for instance, two-story houses are not compared with ranch-style houses.

**Adjustments**

In the preparation of a market value analysis the use of adjustments is of prime importance. Some of the adjustments appraisers look for include the following:

1. **Time.** Since market conditions change, the comparables used are kept within a short time span, usually six months to one year, depending on how volatile the current market is.
2. **Age.**
3. **Location.** Understanding the differences in neighborhoods that affect lot value (location does not affect building value).
4. **Lot size.**
5. **Quality of construction.** This should not be confused with the condition; if the quality is higher or lower than normal for the area, a reasonable adjustment should be made.
6. **Porches, decks, and patios.**
7. **General condition.** The cost of updating a house to bring it to the standard of other houses in the area is considered. This can include the need for exterior paint, new roofing or siding, and landscaping. Interior refurbishing would include painting, new carpeting, and wallpaper.
8. **Living area.** The appraiser uses the outside measurements in determining the square footage.
9. **Number of bedrooms.**
10. **Baths.** Consideration is given to tiled baths, full, 3/4, or 1/2 baths.
11. **Basements.** Full, half, and walkout basements and whether they are finished and the quality of the finished work are considered.
12. **Garages.** Detached, single, double, or triple garages add to or detract from value.
13. **Air conditioning and heating systems.** Age, adequacy, and energy efficiency affect the value.
14. **Fireplaces.**
15. **Extras.** Built-in appliances, garage door openers, and any special amenities the house may have are taken into account.

Figure 16.1 indicates the process used in comparing residential properties. Let us analyze each step. Our subject property is at 1040 Clear Street, which is the model used throughout this book.

Remember, **adjustments must be made to the comparable properties and not to the subject.** This is sometimes difficult to understand. Think of it in these terms: since the value of the subject property is unknown, we cannot make adjustments to it. Also important is understanding how the adjustments are made. If a property has less than the subject property it is given a plus. If it has more, it is given a minus. Thus, the appraiser must **add to the lesser property and subtract from the better property.**

A. This line lists the property addresses. All three comparables are in the same subdivision as the subject property.

B. This line states the sale price of the comparable properties.
C. Line C allows for the change in value that occurs since the date of sale. The appraiser must track carefully any economic changes that have occurred since the sale date of the properties. If property is selling for less, it will be necessary to adjust the comparables down. In the example, the area is in demand, and properties do not have a long market time even though prices have leveled off and inflation has slowed. In view of this information, comparable #1 needs no adjustment since it sold just one month ago. Comparable #2 sold six months ago, and its value has increased 2 percent, and comparable #3 sold three months ago and has a 1 percent increase.

D. and E. No adjustments are necessary here since there are no variations.

F. Property #1 is 50 square feet smaller, so considering that the cost per square foot is $50.00 × 50 square feet, $2,500 is given to the property. Comparable #2 has 50 square feet more, so we give it $2,500.

G. Style and construction of the properties are all the same.

H. Comparable #2 has a one-car garage, so we added $1,500. This takes into consideration that it would be worth an additional $1,500 if it had an extra garage.

I. Allowance needs to be made for the differences in the age and condition of properties. Comparable #1 is only two years old and in excellent condition. Since it is five years newer than the subject and in excellent condition, a minus $2,500 is given. Comparable #2 is the same age as the subject property; however, its condition is excellent, so a minus $1,000 is credited to it. Comparable #3 is ten years old so it has developed three years of additional depreciation, and $1,800 is added to it.

J. The lot sizes vary so slightly that no allowances are made.

K. Special features can have a great affect on the sale price of a property. Wood decks and fenced yards are very fashionable in this area. While comparable #2 has neither, it does have a spectacular view that the appraiser felt “equaled out” not having the former. Properties that are treed, that offer privacy, or that are unusually well landscaped have amenities that also enhance value. Houses with professionally decorated interiors, that sparkle with cleanliness, or that have extra features such as built-in appliances, skylights, and Jacuzzis have enhanced market value.
L. The financing involved in the sale can influence the price paid for the property. If a seller carries financing or an existing loan is assumed, the purchaser may pay more for favorable loan terms. The appropriate adjustments were made on comparables #1 and #3.

M. The net adjustments are totaled.

N. The adjusted market price reflects the adjustments.

O. When looking at the three comparables, no correlation is necessary since the three properties are all very similar to the subject property. We give equal value to each of the properties, and the indicated market value is $85,000. After the correlation of the properties, the appraiser states the conclusion, and the final step for the appraiser is to certify the report.

Cost Approach

The cost approach to appraising is sometimes referred to as the replacement cost method or the summation approach. The cost approach is used when appropriate or when comparable sales are not available. In implementing the cost approach, there are four methods that can be followed:

1. The square foot method involves taking cost data from recent construction of a similar structure and dividing it by the square footage of the building, thus establishing the cost per square foot of that structure. If it cost $90,000 to build a 1,500-square-foot house, the cost per square foot would be $60. The contractor figures the cost of a house by multiplying the square feet in the plan (length × width = sq ft) by the cost per square foot. Thus, 1,500 square feet (area) × $60 (cost per square foot) = $90,000.

2. The cubic-foot method requires calculations that resemble the square foot method, except that the cubic-foot method considers the volume of a building (length × width × height). This method is not used for appraising houses, but it is used for arriving at a value for warehouses and other industrial type buildings.

3. The unit-in-place cost approach method may be used by a contractor in determining the cost of a new building. In this approach, the cost of all component parts, including the kitchen cabinets ($18,000), the fireplace ($3,000), and so on, are computed.

4. The quantity survey method gives the contractor a very precise cost breakdown. This is the most detailed approach to appraising. For example, 42 kitchen cabinet hinges may cost $2.00 each or 19 drawer pulls $2.50 each. The cost of the labor is then added, and contractors can come very close to figuring the exact cost of constructing the house. They can then decide the percentage of profit they desire for their time and labor and add this to the cost of the building. The cost approach is used on special purpose buildings such as schools, police stations, or new construction. There is a difference between replacement cost and reproduction cost.

Replacement cost is constructing a building similar in design and quality to the subject property, using current costs with the materials that are available at this time. Any depreciation that has accrued on the subject property is accounted for.

Reproduction cost means recreating the structure exactly as it is. This involves estimating the actual reproduction costs at the date the appraisal is made. To actually reproduce a structure would probably not be feasible, as there would be disadvantages in addition to benefits, especially if the building is outdated. The cost of producing a duplicate does not lend itself to what a typical buyer would pay for the property. If concessions are made and changes allowed it will no longer be an exact reproduction.

The steps followed in the cost approach are as follows:
1. Estimate the value of the site as if it were vacant and used to its highest potential as governed by covenants and zoning laws. An estimate is also made on any improvements to the site.

2. Estimate the cost to replace the improvements at today’s prices.

3. Deduct depreciation, physical deterioration, functional obsolescence, and exterior obsolescence.

4. Deduct all depreciation from the replacement cost to arrive at the present value of the improvement.

5. Add the land value and improvement value together for the total value of the property.

Remember that in the cost approach the formula is: replacement cost less depreciation plus land value equals the appraisal value. Figure 16.2 indicates how the appraised value of the example property located at 1040 Clear Street was determined. The appraiser did not feel the seven-year-old residence suffered from functional or economic obsolescence. The annual physical depreciation of .5 percent was multiplied times the seven years, and the resulting 3.5 percent was then multiplied times the replacement cost (including the concrete). Most lenders now require appraisers to use the form approved by the secondary mortgage market (Freddie Mac and Fannie Mae), to facilitate the sale of the mortgage to this market (see Figure 16.3).

**Depreciation**

In using the cost approach method, the appraiser must determine if there is any depreciation. Depreciation of the property is subtracted from the replacement cost of the structure. Depreciation of real estate is defined as loss of value from any cause. It includes physical depreciation, functional obsolescence, and economic obsolescence.

**Physical depreciation** includes the normal wear and tear of a structure through use and the actions of natural elements. This form of depreciation may be curable or incurable. Curable depreciation may include the need for painting and decorating or the repair of leaking faucets or malfunctioning electrical outlets. Curable depreciation
FIGURE 16.3
Uniform Residential Appraisal Report.

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<tr>
<td>Foundation</td>
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<tr>
<td>Roof Type</td>
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<tr>
<td>Exteriors</td>
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<tr>
<td>Interior</td>
<td></td>
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<tr>
<td>Appliances</td>
<td></td>
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</tr>
<tr>
<td>Heating</td>
<td></td>
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<tr>
<td>Cooling</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Kitchen</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Bathroom</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Outdoor Areas</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Fencing</td>
<td></td>
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<tr>
<td>Landscaping</td>
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<tr>
<td>Structures</td>
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<tr>
<td>Other</td>
<td></td>
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</tr>
<tr>
<td>Comments</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Note: These are not the final appraisal reports that are submitted to the appraisal board.

Factors that affect the marketability of the properties in the neighborhood are as follows:

- Income levels and characteristics:
- Local economic conditions:
- Local unemployment levels:
- Local crime rates:
- Local access to public transportation:
- Local quality of schools:
- Local availability of public services:
- Local availability of recreational facilities:

Legal and other considerations:

- Local zoning laws:
- Local building codes:
- Local environmental regulations:
- Local historical preservation regulations:
- Local floodplain regulations:
- Local utilities and services:
- Local public transportation systems:

(continued)
### FIGURE 16.3
Continued.

<table>
<thead>
<tr>
<th>ITEM</th>
<th>SUBJECT</th>
<th>COMPARABLE NO. 1</th>
<th>COMPARABLE NO. 2</th>
<th>COMPARABLE NO. 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>BLDG</th>
<th>NO.</th>
<th>BLDG</th>
<th>NO.</th>
<th>BLDG</th>
<th>NO.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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</tbody>
</table>

Continued on next page...

### Part Three
Other Aspects of Real Estate
covers items that have not been maintained but can be remedied at reasonable cost. Incurable depreciation occurs when an item is still serviceable but will need replacement before the economic life of the structure is depleted. Economic life refers to the period over which a building can be profitably utilized.

**Functional obsolescence** refers to the changes in design and construction that outdate a building. Curable functional obsolescence results from inadequate electrical wiring for today’s use, outdated equipment, the need for modernizing a bathroom or installing new kitchen counters and cabinets. Incurable obsolescence is the result of a poor floor plan or a serious lack of closets. A five-bedroom house with only one bathroom and with no space to add a second bath suffers from functional obsolescence. (Undoubtedly, it also suffers from a very crowded bathroom!) As a house ages it competes with new construction and any modern amenities it may have.

**Economic obsolescence** is the most difficult for the property owner to control since it relates to conditions external to the property, such as the desirability of the neighborhood or changes in nearby land use. The value of a property might be diminished if the surrounding structures are not compatible. Overimprovement of a home may also result in economic obsolescence, since a $90,000 home surrounded by $50,000 homes would be less likely to attract $90,000 purchasers.

**Income Approach**

The **income approach** is also referred to as the **capitalization approach** to value and is based on the net income produced in relation to the value of the property. The appraiser determines what the anticipated future income will be and converts that to present property value. Application of the income approach is useful to the person desiring to purchase an investment property. Since risk is involved, the investor will want a greater return than a money market or savings account would bring. The income approach gains importance when the property being appraised is older, and the cost approach is less convincing because of depreciation consideration. First, we will examine the rent multiplier used in the income approach to value, a simplified version of the capitalization method.

The gross monthly rent multiplier (GMRM), or often simply stated as the **gross rent multiplier (GRM)**, is used for one- to four-family residential properties. The **gross income multiplier (GIM)** is used on commercial and industrial income property.

**Gross Rent Multiplier**

The indicator of value can be obtained from similar rental properties with a figure known as the **gross rent multiplier**. It is calculated by dividing the selling price of comparable properties by the gross monthly income to obtain the gross rent multiplier (GRM).

A brief analysis of the steps used in the income approach for single-family residential property follows:

1. Properties recently sold and rented are used as comparables.
2. The selling price of each property is divided by its gross monthly rent to obtain the GRM.

<table>
<thead>
<tr>
<th>COMPARABLES</th>
<th>DATE</th>
<th>PRICE</th>
<th>INCOME</th>
<th>GRM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>12-98</td>
<td>$68,000</td>
<td>$575</td>
<td>118.26</td>
</tr>
<tr>
<td>2</td>
<td>1-99</td>
<td>$71,000</td>
<td>$600</td>
<td>118.33</td>
</tr>
<tr>
<td>3</td>
<td>2-99</td>
<td>$73,500</td>
<td>$625</td>
<td>117.60</td>
</tr>
<tr>
<td>4</td>
<td>3-99</td>
<td>$74,750</td>
<td>$650</td>
<td>115.00</td>
</tr>
<tr>
<td>Subject</td>
<td>Today</td>
<td>?</td>
<td>615</td>
<td>?</td>
</tr>
</tbody>
</table>
3. Working from the table shown, greater consideration should be given to the examples that are most similar to the subject, and the multiplier is determined from this information.

4. If the multiplier used is 117.80, we would take the monthly rent from the subject property and multiply it times the GRM; thus $615.00 \times 117.80 = \$72,447.00$.

Thus, the subject property rent \times the GRM = subject's value.

This same formula can be used on commercial and industrial income-producing properties by using the gross annual income multiplier (GIM). Care must be employed by the appraiser not to use overstated income estimates or the property will have an inflated estimated value. Furthermore, gross income, whether monthly or annual, does not take into account the cost of operating the property nor are allowances for vacancies and rent collection used. The multiplier method of establishing value is a quick means of validating the authenticity of the cost and comparison approaches.

**Income-Producing Properties**

The income approach, based on the net income produced by a property, is used to determine value following this simple procedure:

1. Estimate the potential gross income (PGI) the property is capable of producing. Subtract from potential gross income amounts for vacancies and rent loss. This gives you effective gross income (EGI).
2. Subtract operating expenses from the effective gross income to arrive at the net operating income (NOI). Once a history of the property is established, a pattern is set, and deriving the property's value becomes easier.
3. Determine which capitalization rate should be used. An overall capitalization rate can be extracted from the data on property recently sold by taking the net income and dividing it by the selling price.
4. Apply the capitalization formula: net income \div capitalization rate = value.

Capitalizing involves converting future income to present value. Capitalization rate provides for the return of the investor's capital and a return on the capital invested (the recapture rate). See Figure 16.4 for an example of the income approach to value. Both the GRM and the GIM multipliers use gross income figures regardless of any vacancies or operating expenses; the capitalization rate uses net income.

The simplest method to determine what to pay for a property is to decide what rate of return is desirable and divide the net income by the rate of return. For example, if a building produces $15,000 net per year and the investor wants a 10 percent return, it is feasible to spend $150,000 for the property: $15,000 \div 10\% \text{ (or .1)} = \text{ $150,000}.$

\[
\text{Income} \quad \frac{\text{Rate}}{\text{Value}} \quad \frac{\$15,000}{10\%} \quad = \quad \$150,000
\]

Other factors that must be taken into consideration are covered in Chapter 15.

The appraiser needs to analyze the rental history, with past and present rentals serving as guides in estimating future rentals. Comparing what competitive properties are renting for in the area will be another important factor in determining value. Any change in rent anticipation will need to be documented and supported by the appraiser. Not only the quantity of rent but its durability is taken into consideration.

The appraiser will answer the following questions:

1. Is the contract rent high but of short duration?
2. Does the property have long-term, below-market-rent leases?
3. Is the property managed responsibly so that its value will be maintained?
4. What has been the past rental history of the property?
5. If the property is a regional shopping mall:
   a. Is there anchor power by a national chain, such as Penney’s or Sears, that will bring customers to the site?
   b. Will the surrounding market support the mall?
   c. What is the household income of the consumers nearby?
6. Is the location premier, marginal, or off the beaten path?

**Correlation of Value**

Any one of the three mentioned approaches to value may be used to determine the appraisal of the subject property, but they will not necessarily yield the same value. It may be that replacing a structure would cost less than the prevailing market value if the demand were especially great.

In income-producing property, the capitalization approach is usually given the most credence. If the subject is a single-family dwelling, the income approach is generally not used. The use of the cost approach is of value if the home is comparatively new. The market value would probably come closest to the real value of our example..

---

**OPERATING STATEMENT**

**Potential gross income (PGI) (annual)**
- 10 units @ $300 per month $3,600 (annual)
- 15 units @ $275 per month $4,950 (annual)

**Laundry facility income**

**Annual gross income**

**Vacancy and rent loss (5%)**

**Effective gross income (EGI)**

**Expenses**

**FIXED EXPENSES**
- Real estate taxes $7,200
- Insurance 1,100 ($8,300)

**OPERATING EXPENSES**
- Management (resident 6%) 4,900
- Utilities (water, gas, electricity) 2,100
- Maintenance and repair 3,200
- Redecorating 1,800
- Replacement (appliances, equipment) 2,600
- Accounting services 700
- Advertising 500 ($15,800)

**Total expenses**

**Net operating income (NOI)**

If the capitalization rate is 12 percent, the indicated value will be:

\[
\frac{57,625}{.12} = \$480,208
\]

FIGURE 16.4

The income approach to appraisal.
property. If the appraisal is to be made on a property for which recent comparison
sales are not obtainable, for example, a pickle factory, a library building, or a church,
the cost approach will probably carry the greatest weight.

When reconciling for any spread between the three different approaches, the
appraiser will weigh the average to the most applicable approach. The final step in the
appraisal procedure is the written report. The purpose of the appraisal will determine
the length and depth of the formal report.

THE APPRAISAL REPORT

Delivery of the report may be by one of four methods: an oral report, a letter, a form
appraisal, or a narrative report. The reports may vary in length and type depending on
the request from the client. Regardless of the type of report submitted, the appraiser
has gathered his information by the same process.

The minimum requirements of any report should include the following:

1. identification of the property
2. purpose of the appraisal
3. date valuation was made
4. data used to support the conclusion
5. statement of any limiting conditions and appraiser assumptions, if any
6. indication of value
7. certification by appraiser
8. signature of appraiser

The oral report is given verbally by the appraiser, either in person or by telephone,
to the person who requested the appraisal. There is no documentation to substantiate
the findings, so an oral report is used only when time is of the essence and a quick
report is needed.

The letter report is a formal written appraisal in letter form that identifies the
property, states the purpose of the appraisal, and briefly summarizes the appraiser's
findings. Usage of this simplified form is not encouraged among the professional
appraisers since pertinent and crucial facts could be omitted. No data analysis or
supporting information is included in the letter report. The appraiser will have made a
complete appraisal and will retain this information in his permanent files as support
for the report.

The form report is used extensively by appraisers who need a standardized method
for their clients or employers. Mortgage lenders and mortgage insurers generally
request use of the approved FNMA (Fannie Mae) and FHLMC (Freddie Mac) form,
since they often anticipate selling their loans on the secondary market. All the require-
ments of an FHA and a VA report are on this form, eliminating any problem of
missing facts (see Figure 16.3).

The form report contains the appropriate boxes to check and blanks to complete.
The appraiser has the responsibility to add any additional comments pertinent to the
findings. Currently this form is the most popular means of submitting appraisals.

The narrative report permits the appraiser to present the appraisal in summary
form. A narrative report can contain a very few pages or a hundred pages. The appraiser
must use good judgment in not becoming too elaborate in her writing. Many begin the
report with a one- or two-page synopsis of the findings, enabling the reader to obtain a
quick overview of the appraisal. The reader can then proceed through the report for ver-
ification and substantiation of the appraiser's opinion of the property's value. The
narrative includes the complete steps taken in the analysis used in reaching the conclu-
sion. Included are neighborhood data and exhibits of the comparable properties used to
substantiate the appraisal. An outline of the report would include the following:
THE PROFESSIONAL APPRAISER

Appraisal is the most specialized division of the real estate business, and becoming an appraiser requires comprehensive training. The farm appraiser's expertise will differ from the residential or commercial appraiser's knowledge. Just as the property manager (Chapter 14) specializes, so does the appraiser. The importance of accuracy cannot be overstated. The independent fee appraiser is a disinterested third party who follows an orderly process in determining the value of a property. The appraiser certifies that no present or future contemplated interest in the real estate being appraised exists and that the employment or fee is not contingent upon the determined value.

In the early 1980s appraisers came under the scrutiny of the Federal Home Loan Bank because lending institutions held large numbers of defaulted loans on properties that were overvalued. If the owner of a highly leveraged property needed to sell and found the market value to be less than the loan, defaults occurred. Additionally, with the vast number of homeowners refinancing their properties in 1986, when interest rates plunged to a long-time low, lenders were concerned that, with the rush for refinancing and the resultant backlog of appraisals, carelessness could occur.

The National Association of Review Appraisers and Mortgage Underwriters has developed a form to be used in the review of narrative or residential appraisal reports. It is their intent that use of the form will substantially reduce loan loss of financial institutions by calling attention to the strengths and weaknesses of the appraisal report that lenders rely upon when making real estate loans. It is, however, the function of the autonomous reviewer to see that the valuation is based on sound judgment (see Figure 16.5).

In August 1989, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA). Due to the many failed savings and loan institutions, the appraiser came “under the gun” for careless and shoddy appraisals. As a
### FIGURE 16.5
Residential appraisal review form.

**RESIDENTIAL APPRAISAL REVIEW FORM**

- **Lending Institution**
- **Lender’s Address**
- **Name of Borrower**
- **Property Address**
- **Loan Number**
- **Lender’s Appraiser**
- **Appraiser’s Address**
- **Appraised Value $**
- **Date**
- **Review Appraiser**
- **Reviewer’s Address**
- **Reviewer’s Value Opinion $**
- **Variances To**

The reviewer will analyze the appraisal in light of the following questions. In addition, the reviewer will summarize the results of his or her analysis by completing the “Reviewer’s Comments” appearing at the end of each section. Questions that do not apply can be marked “NA.”

<table>
<thead>
<tr>
<th><strong>FORMAT AND PRESENTATION</strong></th>
<th><strong>LENDER SECTION</strong></th>
<th><strong>YES NO</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is the appraisal report in conformance with company appraisal requirements?</td>
<td>Reviewer’s Comments</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>NEIGHBORHOOD SECTION</strong></th>
<th><strong>YES NO</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Is the neighborhood section of the report complete and accurate?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>7. Have all fair and poor ratings in the neighborhood section been explained?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>8. If marketing time is over six months, has the appraiser commented on the reasons for slow market conditions in the subject area?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>9. If the market is slow, has the appraiser indicated whether or not this has resulted in a decline in values?</td>
<td>Reviewer’s Comments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>SITE SECTION</strong></th>
<th><strong>YES NO</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>10. Is the site section of the appraisal report complete and accurate?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>11. Has the appraiser commented on unfavorable site factors?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>12. Does the appraiser indicate whether or not the subject property meets all the criteria for a desirable lot in the area?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>13. Has the appraiser addressed and commented on problems relating to poor drainage, flood conditions, adverse easements, encroachments or dimensional factors?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>14. Does the appraiser indicate the subject’s zoning and whether or not the subject conforms with present zoning requirements?</td>
<td>Reviewer’s Comments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>IMPROVEMENTS SECTION</strong></th>
<th><strong>YES NO</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>17. Is the improvement section of the report complete and accurate?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>18. If the subject property is a condominium, are the project improvements and project rating sections complete and accurate?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>19. Did the appraiser comment on physical and functional inadequacies and indicate whether or not repairs and modernization are needed?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>20. Has the appraiser explained fair or poor improvement ratings?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>21. Does the appraiser indicate whether or not factors receiving poor or fair ratings adversely affect the property’s marketability?</td>
<td>Reviewer’s Comments</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>FINANCIAL SECTION</strong></th>
<th><strong>YES NO</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>22. Have factors relating to age, condition, quality of construction, finish and equipment, as well as size and utility been properly handled?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>23. Has the appraiser given serious attention to structural problems?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>24. Did the appraiser comment on unusual layouts, peculiar floor plans, inadequate equipment and amenities?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>25. Has the appraiser indicated whether or not factors relating to unusual layouts, peculiar floor plans, inadequate equipment and amenities, limit the value and market appeal of the subject?</td>
<td>Reviewer’s Comments</td>
</tr>
<tr>
<td>26. If there is evidence of dampness, termites or settlement, did the appraiser comment on these factors?</td>
<td>Reviewer’s Comments</td>
</tr>
</tbody>
</table>
CHAPTER SIXTEEN  The Appraisal Process

FIGURE 16.5  Continued.

IMPROVEMENTS SECTION Continued

| 27. Has the appraiser provided the reviewer with a clear and accurate understanding of the physical and functional attributes of the subject property? | YES / NO | 31. In the reviewer's opinion, is the descriptive section of the appraisal report (page one) acceptable? 
Reviewor's Comments |

| 28. Is the property rating section accurate as well as consistent with other data contained in the report? |

| 29. Has the appraiser presented information on construction features in a manner that gives an accurate and adequate view of the subject property? |

| 30. Has information relating to the improvements been well handled? |

COST SECTION

| 32. Is the cost section complete and accurate? |

| 33. Are the appraiser's measures for gross living area correct? |

| 34. Has the appraiser commented on functional and economic obsolescence? |

| 35. In estimating reproduction costs, has the appraiser used cost figures that are appropriate for the local market? |

| 36. Do figures for physical, functional, and economic obsolescence appear reasonable in light of the subject's age, condition, state of modernization, size and utility, and location? |

| 37. Is the estimate of land value appropriate? |

MARKET ANALYSIS SECTION

| 41. Is the market analysis section complete and accurate? |

| 42. Has the appraiser selected his or her comparables from the subject neighborhood? |

| 43. If not, has the appraiser explained why comparables were selected from a different neighborhood? |

| 44. In your opinion, are the same conclusion of value as the appraiser? |

| 45. Do the figures for physical, functional, and economic obsolescence appear reasonable in light of the subject's age, condition, state of modernization, size and utility, and location? |

| 46. Are the comparables recent sales of similar properties from the subject neighborhood? |

| 47. If the comparables are over three months old, has the appraiser explained why he or she failed to use recent sales? |

| 48. Are room counts and square foot areas of the subject and comparables similar? |

| 49. Do the sales prices and price per square foot of the comparables correlate and indicate comparability? |

| 50. Are there large differences in the price per unit and per square foot between the subject and comparable properties? |

| 51. Does the appraiser have or use sales data before moving adjustments? |

| 52. Does the appraiser make any adjustments for dates of sale, apparent reasonableness in light of market trends and current market conditions? |

| 53. Has the appraiser made excessive adjustments (gross and/or sales prices, and individual line adjustments that are less or more of comparable sales prices)? |

| 54. Has the appraiser adjusted all three comparables in a reasonable and consistent manner? |

| 55. Does the appraiser make unsupported or faulty adjustments? |

| 56. Is there missing or inaccurate information in the market analysis section? |

| 57. Are the appraiser's mathematical calculations accurate? |

| 58. Is there a convincing value range with respect to the three adjusted comparables? In other, are the adjusted value conclusions reasonably similar? |

| 59. Does the appraiser's final value conclusion relate to the adjusted comparables? |

| 60. Has the appraiser selected good market data and handled it well? |

| 61. Has the appraiser commented on the subject's marketability? |

| 62. Does the appraiser's marketability information appear to be accurate? |

REVIEWER'S SUMMARY

(To be completed by the lender's appraisal, quality control or underwriting department)

Appraisal Report was: Acceptable Unacceptable

Recommendations, comments and summary of action taken (if any).

Reviewor's Signature Date of Review

Review Form No. 2002
result, Title XI was attached to the FIRREA bill. Title XI provides for the regulation of appraisers in all federally related transactions. With a deadline of January 1, 1992, many states rushed to enact legislation in compliance with the federal requirements. An extension was granted to January 1993. All appraisals that are federally related must be performed by certified or licensed appraisers. As of July 1, 1991, lenders must use state-certified appraisers if they want to sell their mortgages to the secondary market. The appraisers are required to meet minimum standards, which include a written report performed in accordance with appraisal standards.

**The Uniform Standards of Professional Appraisal Practice (USPAP)**

The set of rules that regulates the preparation of appraisal reports is the Uniform Standards of Professional Appraisal Practice (USPAP). These rules spell out the ethical and technical guidelines appraisers must comply with when determining an appraisal value for use in a “federally related” transaction. One provision of the USPAP is that the appraiser, when estimating the value of a parcel of real estate, must employ all three approaches to value: comparison, cost, and income. USPAP further states that if the appraiser chooses not to consider all three approaches, the appraisal report must state which approach was not considered and why the appraiser feels it does not apply to the subject property. The criteria are as follows:

<table>
<thead>
<tr>
<th>1–4 FAMILY RESIDENTIAL</th>
<th>COMMERCIAL PROPERTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 million and higher: Must use a certified appraiser</td>
<td></td>
</tr>
<tr>
<td>$250,000–$999,999: May use a licensed appraiser; a financial institution may presume that residential property is not complex unless the institution has readily available information to the contrary</td>
<td></td>
</tr>
<tr>
<td>$100,001–$249,999: May use a licensed appraiser even if the property is complex</td>
<td></td>
</tr>
<tr>
<td>$0–$100,000: No appraisal required; however, most institutions will require an appraisal</td>
<td></td>
</tr>
</tbody>
</table>

Even before the enactment of FIRREA, 17 states had already required appraisers to be licensed or certified. Continuing education and minimum standards of performance are criteria sought by the appraisal institutes and societies. Most states require licensees to fulfill the following requirements for state certification:

1. 2,000 hours of appraisal work experience
2. 60 hours of basic appraisal education
3. 15 hours of Uniform Standards of Principles and Practice (USPAP)
4. successfully pass an examination

The appraiser needs to be state certified to

1. appraise federally related commercial transactions of more than $250,000
2. appraise residential properties of more than $1 million

*The 17 states are Arizona, Colorado, Delaware, Georgia, Indiana, Michigan, Minnesota, Mississippi, Nebraska, Nevada, New Mexico, Oregon, South Carolina, Tennessee, Utah, Virginia, and West Virginia.*
3. appraise complex residential properties of more than $250,000
4. appraise residential properties of more than four units
5. successfully pass an examination

For general certification the appraiser is required to

1. complete 1,000 hours of residential experience and 1,000 hours of commercial education
2. complete 150 hours of course work (if the state has a residential certification available, the course work is reduced to 105 hours)
3. complete 15 hours of the Uniform Standards of Principles and Practices (USPAP)
4. successfully pass an examination

In some areas of the country, lenders request that appraisers fill out environmental on-site inspection forms. While appraisers already have a responsibility to make note of any condition that could affect the property value through normal research, as they perform the appraisal there is concern over items that cannot readily be observed. Is the appraiser liable to know if there are underground storage tanks? The appraiser needs to inform the client that the appraiser is not an environmental expert and can only observe any existing problems. The appraiser also needs to take care not to report any conclusion about past, present, or future contamination. As more and more responsibility is heaped upon the appraiser, a disclaimer on such issues as environmental hazards and toxic waste should accompany the report.

As professionalism has developed among appraisers, organizations and designations have followed. Today there are many professional appraisal organizations that offer designations and certification to indicate the appraiser's qualifications and knowledge. Rigid appraisal education requirements must be met by appraisers seeking membership and designations in these associations. With local chapters across the country, techniques are taught for appraising urban, rural, and industrial properties.

The Appraisal Institute was formed in January 1991 by the merger of The American Institute of Real Estate Appraisers (AIREA), which awards the RM and MAI designations, and the Society of Real Estate Appraisers (SREA), which awards the SRA, SRPA, and SREA designations. The Appraisal Institute offers continuing education to keep appraisers abreast of industry changes.

While there are many more facets involved in the appraisal of real estate, the techniques and definitions presented here should be adequate to introduce you to the field of appraisal. In-depth studies of land and building residual techniques and complete detailed appraisal reports can be found in textbooks written strictly on appraisal.

**SUMMARY OF IMPORTANT POINTS**

1. An appraisal is not an exact science, but an estimate of value
2. There are three main appraisal techniques: the cost approach, the sales comparison approach, and the income approach.
3. The appraisal procedure is carried out in a sequence of steps, from defining the problem and collecting the data to analyzing the subject property and applying one or more of the three approaches.
4. Depreciation is loss from any cause, affects value, and is caused by physical depreciation, economic obsolescence, and functional obsolescence.
5. The highest and best use of the property and the various principles involved in creating value are discussed in the chapter.
DISCUSSION POINTS

1. How are adjustments for the differences in properties applied by the appraiser?
2. Explain the three approaches to value and describe when each is used.
3. Differentiate between market value and market price.
4. Why is it necessary for the appraiser to know the reason for an appraisal? Isn’t value the same regardless of the purpose for the appraisal?
5. Explain the principle of progression and regression.
6. List the sequence of steps an appraiser follows in arriving at the value of a property.

REVIEW QUESTIONS

Answers to these questions are found in the Answer Key section at the back of the book.

1. In preparing an appraisal report, the appraiser’s first step is to:
   a. collect the data
   b. apply the cost approach
   c. write the appraisal report
   d. define the problem

2. Functional obsolescence is due to:
   a. normal wear and tear
   b. inadequate design or floor plan
   c. lack of exterior maintenance
   d. rezoning of surrounding land

3. On what type of property would the cost approach be the most accurate?
   a. a 6-month-old residence
   b. an apartment house
   c. an older property with economic obsolescence
   d. a 15-year-old residence

4. The market value of a property is commonly defined as:
   a. the highest and best use of the property
   b. the highest price at which a willing seller will sell and a willing buyer will buy
   c. the income the property is annually producing
   d. amenities attached to the property

5. The definition of depreciation is:
   a. loss in value from any cause
   b. mortgage foreclosures
   c. loss from scarcity of a product
   d. none of the above

6. Physical depreciation is brought about by:
   a. conditions outside the property
   b. functional obsolescence
   c. normal wear and tear
   d. economic conditions

7. Economic obsolescence is related to:
   a. lack of closet space
   b. poor drainage in the yard
   c. faulty heating systems
   d. conditions external to the property

8. A four-bedroom home with one bathroom suffers from:
   a. economic obsolescence
   b. functional obsolescence
   c. physical depreciation
   d. economic depreciation

9. If a property has a gross monthly income of $930 and the gross rent multiplier is 112.00, which of the following is the estimated value of the property?
   a. $83,035
   b. $104,160
   c. $1,046,000
   d. $8,303,500

10. The formula of replacement-cost-less-depreciation-plus-value-of-land is called the:
    a. income approach
    b. market data approach
    c. comparison approach
    d. cost approach
11. The summation or cost approach to value is best used on:
   a. apartment complexes
   b. service-type buildings
   c. land
   d. older homes

12. The depreciation most difficult to remedy would be:
   a. physical depreciation
   b. economic obsolescence
   c. normal wear and tear
   d. functional obsolescence

13. Which of the following is the capitalization formula used to arrive at value?
   a. \( \frac{\text{net operating income}}{\text{cap rate}} = \text{value} \)
   b. \( \frac{\text{gross income}}{\text{cap rate}} = \text{value} \)

14. Utilizing a property to its greatest economic advantage is commonly referred to as:
   a. mobilization
   b. economic utility
   c. market value
   d. highest and best use

15. When applying the cost approach to value, the appraiser allows for depreciation:
   a. on land
   b. on improvements
   c. on personal property
   d. on neighboring property

16. Which of the following is not a factor to consider when using the comparison approach to value?
   a. date of sale
   b. physical features and amenities
   c. current monthly rent
   d. financing concessions

17. The square foot method used in the cost approach involves using which of the following formulas?
   a. \( \text{length} \times \text{width} \times \text{height} \)
   b. \( \text{length} \times \text{width} \)
   c. \( \text{number of drawer pulls} \times \text{cost of one drawer pull} \)
   d. \( 2 \times \text{length} \times \text{width} \times \text{height} \)

18. A builder may use this method to estimate the price to charge for a house by using this very precise cost breakdown, such as totaling cabinet hinges and all supplies used in the construction, plus adding labor costs:
   a. replacement cost method
   b. square foot method
   c. quantity survey method
   d. cost approach

19. To calculate the present worth of future benefits of a property, which of the following is used?
   a. the capitalization formula
   b. the cost approach
   c. comparable properties
   d. the summation approach

20. Functional obsolescence would least likely include:
   a. rotting wood
   b. poor architecture
   c. an outdated kitchen
   d. bad design

21. A 25-year-old home is sound and in good condition, but has an outdated bath. The bath is suffering from:
   a. normal depreciation
   b. physical obsolescence
   c. functional obsolescence
   d. deterioration

22. The following definition defines market price:
   a. sale price
   b. replacement value
   c. the appraised value
   d. the residual value

23. What value may an appraiser NOT be employed to determine?
   a. market value
   b. loan value
   c. condemnation value
   d. past value
24. A new industry that will employ 350 people will locate in the city. This is an example of which of the following forces?
   a. physical force
   b. sociological force
   c. economic force
   d. political force

25. The best definition of an appraisal is:
   a. a means of determining depreciation
   b. a method to keep values current with reproduction costs
   c. a statement of facts that may not necessarily be true
   d. an estimate of value

26. Based on what you know about the approaches to value, which of the following would not be used to appraise land?
   a. sales comparison approach
   b. income approach
   c. market analysis approach
   d. cost approach

27. The following is a method of valuing property based on the income that it can be expected to generate.
   a. gross rent multiplier
   b. sales comparison approach
   c. summation approach
   d. cost approach

28. When two or more adjoining parcels of land are merged, the increased value is called:
   a. assemblage value
   b. plottage value
   c. salvage value
   d. conformity value

29. When using the comparison approach, the appraiser makes adjustments by:
   a. adjusting the subject property to the comparables
   b. adding value to the superior property
   c. subtracting value from the inferior property
   d. adjusting the comparables to the subject property