

## **CHAPTER 1-INTRODUCTION TO REAL ESTATE APPRAISAL**

- Appraisal: an opinion or estimate of value

### **What is an Appraisal?**

- An estimate or opinion of *value*
  - (1) *value* means the worth or usefulness of something to someone for some purpose
  - (2) it is neither a statement nor a fixing of value
  - (3) an appraisal is a subjective opinion of one person, based on whatever skills, training, data, dedication, and objectivity that person possesses
  - (4) because an appraisal is an opinion/estimate it is not fact
  - (5) the value of real property can depend upon the purpose for which it is being used or will be used, which means that there are different types of values that can be attributed to property depending upon the anticipated use
- the idea of an appraisal is to form an opinion of what is known as the market value (the price it would something should sell)

- the market value is defined as the most probable selling price of a property in a competitive and open market

### **Informal Appraisals**

- we all make informal appraisals of things whatever we consider buying something (like at a garage sale)
- it is difficult for someone to judge whether an informal in appraisal is accurate or not
- we make informal appraisals to judge if the price is reasonable, usually comparing one product with another

### **Formal Appraisals**

- a formal appraisal is an opinion of value that is reached by the methodical collection and analysis of relevant market data
- most often done by people who are specially trained in appraisal work
- a formal appraisal report is the conclusion that is based on the analysis of factual material
- because a formal appraisal is based upon the analysis of factual material, a third party should be able to review the report and understand how the appraiser reached the conclusion
- in contrast, in an informal appraisal, there may be no factual material to help a third-party understand how an appraiser reached a value conclusion
- see the Figure 1.1 on page three

### **How Appraisals Are Used**

- assist the public by advising them on questions of property value
- to provide an unbiased and disinterested opinion of value, where total objectivity is required by business practice or by provision of law
- appraisals in such situations must be formal incapable of being reviewed by third parties

### **Occasions Requiring Appraisals**

- (1) market transactions and (2) legal transactions

### **Market Transactions**

- connected with the sale, purchase, finance, management, and use of real estate
- Example: an appraisal to support a real estate loan
  1. determination of rent
  2. to determine value of properties being exchanged
  3. to estimate proper level of insurance coverage

## Legal Transactions

- 1) Government actions involving real estate and (2) those private actions that take place in legal settings/are regulated by law
- these types of appraisals must almost always be formal and in writing

## Government Actions

- (1) eminent domain and (2) to seize taxation purposes
  - (1) Eminent Domain
    - Government can acquire privately owned property for public purposes
    - you need a condemnation appraisal to determine what they just compensation should be to the owner
  - (2) Property Taxation
    - the property tax appraiser/assessor must assess/estimate the value of real property to determine what the property tax should be over (in California each county has a County Assessor)
    - if a private property owner disagrees with the assessed value, the owner can have their property appraised to determine whether the government evaluation was reasonable
  - (3) Other Legal Situations Requiring Appraisals
    - appraisals are often needed in divorce situations
    - to resolve rental disputes
    - to establish damages to property

## Standards of Appraisal Practice

- like other professional groups, appraisers have come together to create professional associations that sponsor and promotes strict standards of ethics and practice among their members
  - like doctors and lawyers, the idea is that consumers should only use those appraisers who have been admitted into a group of professional appraisers
  - if the consumer uses a member of a professional association, the consumer is more likely to be satisfied with the services provided by the professional association member
- various different appraisal groups came together to formulate uniform appraisal standards that are recognized a professional appraisal organizations throughout North America
  - these uniform rules are known as the Uniform Standard of Professional Appraisal Practice

## (USPAP)

### Ethics Rules

- (1) Conduct: appraisers must conduct their work with impartiality, objectivity, and independence, and without accommodation of personal interests
- (2) Management: no undisclosed fees or commissions, nor can compensation to the appraiser be contingent on the value conclusion reached by the appraiser
- (3) Confidentiality: the appraiser must not reveal confidential factual data obtained from the client, subject to very narrow exceptions
- (4) Recordkeeping: the appraiser must prepare and keep a comprehensive file for each assignment for leased five years after preparation so that a third party can determine how an appraiser determined the value of a given property

### Appraiser Licensee and Certification

- unlike doctors and lawyers, you do not have been member of a professional appraisal organization in order to give an appraisal
- however, many banks and certain federally-related financial real estate transactions must be performed by licensed or certified appraisers (these reports must conform to the USPAP)

## Developing Appraisal Skills

- (1) even if you will not become an appraiser, it is important to understand appraisal skills
- (2) as a real estate agent you need to have an idea of what the market price for property should be so that you can ensure that your client's property is sold at a correct price
  - if the price is too high or too low you may not get your commission or your client will not get the value they deserve for their property
- (3) real estate agents have a fiduciary (special or paternalistic) duty, including the duty to make sure that your client gets the prices they deserve for the property
- (4) real estate agents also need to be able to understand how to communicate with appraisers and how to read appraisal reports
  - see questions on page 24

## CHAPTER 2-LEGAL CONSIDERATIONS IN APPRAISAL

### **Physical and Legal Characteristics of Real Estate**

#### Real Estate, Real Property, and Personal Property

- (1) property: valuable rights held to the exclusion of others
- (2) tangible property: physical objects, things that can be touched
- (3) intangible property: no physical objects, but instead valuable rights or obligations, like stock or a patent
- (4) real property: land and everything that is permanently fastened to the land
- (5) personal property: property that is movable, (everything that is not real property)

#### The Components of Real Property

- real property has four attributes: 1) the land; 2) object permanently affixed to the land; 3) that which is appurtenant, or legally accompanies the land; and 4) that which is immovable by law

#### The Land

- land includes the surface, the soil and rocks beneath, and space above
  - soil and liquid rights are very complicated but can be separated from the surface of a piece of land
  - your rights are what can be reasonably used and enjoyed by a property owner (airplanes do not have to get permission to go over your land)

#### Permanently Affixed Objects

- trees for example or house
- tricky to distinguish between certain things are not clearly attached to land, such as crops
- personal property can be permanently affixed to land in these objects become fixtures of birthday such as cabinets, plumbing, etc.)
  - because the fixtures have become attached to land, they become part of the real estate

#### Appurtenant Rights

- an appurtenance is a right given the owners of one property (the dominant tenement) a right to use another property (servient tenement) in a way that benefits the dominant tenement
  - easements, or rights to water

#### Property: Is It Real or Personal?

#### The Law of Fixtures

- Issue: how to determine whether an object is a fixture or personal property
- what is the intention of the person incorporating the personal property into the land?
  - (1) how permanently is the property attached to the land and building?
  - (2) to what extent is the property uniquely adapted to be used with the land (is a rug cut to specifically fit an odd-shaped room?)

(3) is there any agreement between the parties involved that defines ownership of the property and whether it is to be considered real estate? (often found in leases)

(4) what is the relationship between the person put in the personal property and any other person with a claim to the real estate? (Did a tenant put in the fixture or a landlord?)

#### Using Fixture Law and Appraisals

- in conducting an appraisal, we need to know whether certain objects should be included in the appraisal (meaning they are part of the real estate) and which items to exclude from an appraisal
- when making an appraisal is important to specify which items the appraiser is assuming to be fixtures and which items are assumed to be personal property

#### Real Property Rights

##### Bundle of Rights

- property ownership of rights have been compared to a large bundle of sticks, with each stick representing a different rights regarding the use of property
- these rights include (1) the right to occupy the property; (2) the right to sell it; (3) the right to exclude others from it; (4) the right to borrow against it; and (5) the right to convey ownership by inheritance or gift

##### Fee Ownership

- the most significant form of ownership one can have in real property is a fee interest
  - the pure right to do whatever the owner wants to it is fee simple absolute
  - because of all the forms of government regulation of private property, the most right any property owner really has is fee simple qualified
    - this means that an owner has complete control over piece of land, subject to applicable government regulations

##### Partial Interests

- < fee interest in land
  - examples include a "leasehold estate" or a "life estate"
  - rights in condominium complexes
  - see list on page 19
- connection to appraisal: an appraiser must understand what rights in the property are being appraised, a fee simple interest in a property is worth much more than a life estate for example

##### Use Restrictions

- the possible uses of a property by an owner are determined not just by the owner's plans, but also by various public and private restrictions that affect the property
- an appraiser must understand the applicable use restrictions because such restrictions affect the value of a property

##### Categories of Use Descriptions

- (1) government; (2) private; and (3) market.

##### Government Restrictions

- because historically all property came from grants of the government, there have always been government restrictions on the use of property
- there are four specific rights retained by the government: (1) police; (2) eminent domain; (3) taxation; and (4) escheat

(1) police power: government has the right to regulate property as necessary to promote the safety, health, morals, and general welfare of the public

- zoning and land-use controls

(2) eminent domain: government retains the rights to take back property at any time if it is the public interest to do so, and the government must pay the property owner "just compensation".

(3) taxation: the government may impose taxes on property as necessary to raise funds so long as the taxes are fairly imposed

(4) escheat: the government will take back title to property if the owner dies or disappears and leaves no relatives or heirs

#### *The Police Power and Real Estate*

- the police power is extensive and forms the basis for most government regulation of property, such as zoning, density requirements, heightened size, setback requirements, hours of operation, noise levels, signs, etc.

- using the police power governments can also pass and adopt various types of codes for building, housing, electrical, etc.

- see the list of various police powers on pages 21-22

#### *Private Restrictions*

- developers and property owners are free to impose conditions that restrict future owners or users of the land

- examples include CC & Rs

- deed restrictions (used to include race and religion)

- these types of private restrictions usually show up in preliminary title reports or title searches

- appraisers need to know what restrictions apply to the property, both public and private in order to have an accurate appraisal

- appraisers should actually review the underlying documents that create the restrictions

#### *Market Restrictions*

- each proposed use of land must be financially satisfactory or investors will not choose that use. Proposed uses of land must earn enough money or create enough benefit at that location to justify the cost of the land and the buildings

- therefore uses of land must be *economically feasible*

#### *Potential Use and Value*

- the combination of government, private, and market restrictions determines how land will be used, which therefore determines the value of the land

- a real estate appraiser needs to be aware of all such restrictions that impact to piece of land, and aware of the impact on the current use of the land as well as the possible impact on future uses of the land

#### **Property Descriptions**

- in order to convey property, you need to have a legal description so there is no confusion about which property and/or interest is being transferred

#### *Three Basic Types of Legal Descriptions*

- (1) lot and block number; (2) metes and bounds; and (3) government surveys

- frequently you will see a combination of two or more of the types of legal descriptions (such as a map with lot and block numbers, and a metes and bounds description)

#### **Recorded Lot, Block, and Tract**

- refers to subdivision maps (see page 24)

- Subdivision Map Act

- the subdivision map is usually recorded

- the idea is for third parties unfamiliar with the property to be able to easily determine where the property sets, with reference to these recorded subdivision maps

#### **Metes and Bounds**

- a way of describing property by giving the distance and direction of each boundary line of the property
- can describe things that are not strictly linear, like a radius, precise degrees, etc.
- very long and tedious
- be very careful of typographical errors

### Government Survey

- a map system for describing property that has its roots in a basic survey system created by the US government
- there are three principal meridians, including Mt. Diablo
- see examples on page 27-28

### **CHAPTER 3- THE FORMAL APPRAISAL PROCESS**

- this is a general overview of how appraisals are supposed to be done, according to the 3 standard methodologies
- we will be going in to a detailed examination of each of the processes behind a formal appraisal and later chapters-this is only meant to give you an overview

### Conformity with the USPAP

- under most circumstances an appraisal should be a conformance with the USPAP requirements
  - (1) all appraisals need to comply with the binding requirements of the USPAP
  - (2) appraisals may depart under the Departure Rule under certain limited circumstances, as long as the appraisal notes of the departures from the USPAP

### *Complete and Limited Appraisals*

- in order to distinguish between appraisals that conform to all the provisions of the USPAP and those types of appraisals that are allowed under the Departure Rule, there are two types of appraisals recognized by the USPAP:

- (1) complete appraisal: developing an appraisal without departing from the USPAP
- (2) : developing an opinion of value developed under and resulting from invoking departures from the USPAP

- a complete appraisal is more reliable and more thorough than a limited appraisal, where as limited appraisals are used for certain unique circumstances

### **STEPS IN THE APPRAISAL PROCESS**

- (1) clearly defining the appraisal problem
- (2) formulating an efficient appraisal plan
- (3) collecting and analyzing the pertinent data
- (4) applying the appropriate value approaches
- (5) arriving at a conclusion of value
- (6) reporting the conclusion of value

- see the flowchart on page 37

### **(1) Defining the Appraisal Problem**

- you must identify the problem before you can proceed with an appraisal
- you need to know what is sought to be accomplished by having a property appraised
- by defining the questions to be answered and the goals to be achieved by the appraisal, the appraiser can set the scope of the work and can better meets the exact needs of the client
  - (a) identify the client and other intended users
  - (b) identify the intended use of the appraiser's opinions and conclusions
  - (c) identify the purpose of the appraisal, including the type and definition of the value to be developed

- (d) identify the effective date of the appraiser's opinions and conclusions
- (e) identify the property and property rights to be appraised
- (f) identify the scope of work necessary to complete the assignment
- (g) identify any extraordinary assumptions necessary in the assignment
- (h) identify any hypothetical conditions necessary in the assignment

(a) Identification of the Client

- the key issue to consider is who is going to be using the appraisal? Is it an individual property owner? A bank? An insurance company?

- If you can identify who's going to use the appraisal that can help you better prepare the document

(b) Intended Use of the Appraisal

- depending upon who's going to review the appraisal, there may be many uses or purposes behind the appraisal

- the appraisal may need to contain different sections depending upon the ultimate user

- example: if an appraisal is to be used in a federally-insured loan transaction, the appraisal must conform to the USPAP and any other special rules ` are requirements of the financing agency

- the use of the appraisal may also determine whether it needs to be a complete or limited appraisal (although the appraiser should be clear with the client whether the appraisal is to be complete or limited)

(c) Purpose and Appraisal and Definition of Value

- keep in mind that while the normal purpose of an appraisal assignment is to estimate the market value of a property, appraisals can be requested for other uses, for example to determine the insurable value, the rental value of a property, or the liquidation value

(d) The Effective Date of the Appraisal

- having a specific effective date of the appraisal is important because real estate values fluctuates so much

- it is a good idea to agree in advance what the date of the appraisal should be so that the current value can be defined

- appraisal don't always have to be relatively current, appraisals can be made of the past or future value of a property. Under such circumstances, the appraiser report must identify the data that was used to determine the past or future value

(e) Identification of the Relevant Property Characteristics

- an appraisal must clearly identify the property, if not just by the address but also by a legal description
- the idea is that third-party should be able to easily determine where this property is
- the appraisal should identify those characteristics of a property that are relevant to the proposed and intended use of the property

- if any personal property should be included in the appraisal, the appraisal report should specify that

- is also important to define what real property rights are being appraised

(1) for example are there any easements, special restrictions, or assessments?

(2) is a fee simple interest being appraised or is it something else like a leasehold estate or subsurface mineral rights? (Are we dealing with full or partial rights?)

(f) Defining the Scope of Work

- this is the definition of all the work that will go into developing in reporting and appraised value
- the appraiser and client should agree as to what the scope of what work should be, so that the product is consistent with the client's expectations

- the scope of work will depend upon whether the appraiser is doing a complete or limited appraisal

(g) Extraordinary Assumptions

- appraiser must identify any extraordinary assumptions made in the assignment
- under the USPAP, an extraordinary assumption is an assumption that is related to a specific assignment, which if it were found to be true could alter the appraiser's opinions or conclusions
- under the USPAP, extraordinary assumptions are to be used only when:
  - (1) it is required to properly develop credible opinions and conclusions
  - (2) the appraiser has a reasonable basis for the extraordinary assumption
  - (3) use of the extraordinary assumption will result in a credible analysis, and the appraiser complies with the disclosure requirements set forth in the USPAP

#### (h) Hypothetical Conditions

- hypothetical conditions are rarely used in appraisals, but may be appropriate if a hypothetical condition is needed for legal reasons or for purposes of analysis for comparison
- any use of a hypothetical condition must be developed by credible analysis

#### (2) Formulating the Appraisal Plan

- every appraisal should specify the steps that will be taken so that the appraiser will proceed in an efficient manner
- typically there are three primary components of a plan:
  - (1) preliminary inspection of the property: this is a preliminary survey or preview of the subject property and its surrounding neighborhood
  - (2) list of needed data: all the data that will need to be collected should be identified during the planning stage. If any unusual types of data are needed they should be specified.
  - (3) outline and the work schedule: a flowchart of the order in which the work is to be done, possibly with the time schedule

#### (3) Collecting and Analyzing the Data

- because appraisal must be based upon hard data, appraisers typically collect what is known as *market data*, typically the following three types:
  - (1) general data on the region, city, and neighborhood (socioeconomic data and any data on available financing and construction costs)
  - (2) specific data on the subject property
  - (3) specific data on comparable properties (for purposes of comparing the subject property to other similar properties)

#### (a) Highest and Best Use Analysis

- this is a study of how well-suited the property is to its physical, legal, and economic environment
- the idea is to arrive at a value that represents the best use (meaning most productive) use of the property given in the physical, legal, and economic constraints

#### (b) How Much Information Is Needed?

- Depends upon whether you are doing a complete or limited appraisal, and for what purposes the appraisal is going to be used
- it may also depend upon the client expectations
- you need as much data as is necessary to produce a reliable and legally sound appraisal
  - (1) you need to think of all the ways in which someone might argue with the appraisal that you reached and try to address all of those possible arguments
  - (2) for example be careful of comparing apples and oranges (the example on page 42)

#### (4) Applying the Value Approaches

- there are three methods used to reach an appraisal of the value of a property—we will discuss each of these three in detail

(1) sales comparison approach: use data from the sale of comparable properties, which are often a good indication of the value of any commodity

(2) cost approach: an estimate of the amount required to buy vacant land and the cost to construct the existing and proposed building on it. Any loss in value from age or other causes is subtracted in arriving at a figure that estimates what it would cost to re-create the existing structure.

(3) Income approach: an analysis of the income-producing capability of rental investment property

#### **(5) Arriving at a Conclusion of Value**

- if more than one method of estimating the value of a property has been used, the appraiser will need to reconcile any differences between these estimates

- there are three considerations involved in reconciling differing estimates:

(1) review the appropriateness of each approach used, considering the purpose of the appraisal and the type of property

(2) consider the adequacy and reliability of the data and the validity of any assumptions made in the analysis

(3) consider the range of indicated values and the position of each value within that range

- the final determinant of value is rarely ever based on simply averaging three value estimates, instead an appraiser should analyze what is the most appropriate method given the purpose of the appraisal and the property at issue, while taking into account the appraisals reached by less appropriate methods

#### **(6) Reporting the Conclusion of Value**

##### Types of Written Reports

(1) self-contained appraisal report: contains all the information used in coming up with the appraisal

(2) summary appraisal report: just a summary of the information used to prepare the appraisal

(3) Restricted use appraisal report: contains only a brief statement of the information used

- if the restricted use report is used, there must be a prominent "restriction clause" that restricts reliance on the reports to just the client

- the type of report to be prepared should be decided in advance between the appraiser and the client, based upon the intended use of the appraisal, the knowledge of the users, the significance and complexity of the property to be appraised, and the degree of disclosure in the report

##### Formats of Appraisal Reports

(1) the letter report

(2) form or short-form report

(3) the narrative report

- the letter report is an informal letter that summarizes the conditions of the task, a summary of the work and scope of the appraiser's investigations, and an opinion of the value

- the form report is usually appraisal pre-printed form that some clients like to use as a way to standardize their review of various different types of appraisals (such as institutions and government agencies)

- the narrative report is the longest and most detailed of the appraisal formats, containing a step-by-step description of the facts used by the appraiser to arrive at a value determination is precious gate. Also typically includes the methodology. These are frequently also used by government and investment agencies.

#### **TYPES OF VALUE**

##### **Why Value Concepts Differ**

- there is a need to differ between objective and subjective determinations of values

- what a property is worth to a buyer or seller may be different than what the property would be worth to a lender or insurance adjuster

- an individual buyer will probably value the property in terms of their personal desires and/or needs

- third parties that aren't considering personal use of the property will generally value the property according to an objective view of the market about what the property would bring on an open-market

### **Contrasting Value in Use and Value in Exchange**

(1) value in use means the value of an item to a particular user-this is a very *subjective valuation* concept

(2) value in exchange this describes the value of the thing to people in general-this is the *objective value* of the property

### **Defining Market Value**

- what property should sell for assuming a willing buyer and a willing seller
- the idea is a pure arms-length transaction
- implicit in this idea are the following assumptions:
  - (1) buyer and seller are typically motivated
  - (2) both parties are well-informed or well advised, and each acting in what he or she considers his or her own best interest
  - (3) a reasonable time is allowed for exposure in the open-market
  - (4) payment is made in terms of cash or in terms of financial stop arrangements comparable thereto
  - (5) the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale

### **Terms of the Sale**

- a property may have a different price given the terms of the sale (meaning is the price for cash or for financing)
- the thing to remember is that a price can depend on many factors such as financing, but the value of the property does not
- *price differentiation does not necessarily mean value differentiation*

### **Market Exposure**

- open-market exposure is necessary for a property to realize its real value
- prices resulted from sales lacking adequate open-market exposure are not typical of the open-market
  - (1) transactions among family members are not arm's-length transaction
  - (2) sales of property when the seller is under duress
  - (3) sales of property resulting from a job transfer or family breakup
- there is no standard on what is adequate market exposure, but the more unique the property is the more market exposure the property is going to need because unique properties are of interest to a narrower market

### **Informed Parties**

- for a piece of real estate to earn its true value, potential buyers and sellers must know the highest and best uses and purposes of the property
- the idea of market value is referring to the value of property to those individuals who are and knowledgeable about buying property on the open-market

## **THE CLASSICAL APPROACHES TO VALUE**

### **The Sales Comparison Approach**

- known as the "market approach", this is a comparison of the property being appraised to similar properties that have recently sold on the open-market
- see example 3.1 on page 49
  - (1) investigate sales of comparable properties, determine the goals of the buyers and sellers, and determine what the terms of the sale will be
  - (2) analyze and compare the sales with the subject property, considering variable factors that could affect market value (control for these factors)

(3) judge how the observed differences affect the potential price to be paid for the property under study

(4) arrive at a conclusion of value for the subject property based on the most comparable sales

- be sure to deduct from the price of the subject property desirable features in the comparable properties that are not found in the subject property. Similarly add to the price of the subject property those desirable features that are unique to the subject property

### **The Cost Approach**

- adding the depreciated replacement cost of the improvements to the value of the land as estimated from a market or economics study

- the cost approach is also useful in appraising special use properties which are not frequently bought or sold (meaning there's not much to compare them against)

- one thing to remember about the cost approach is that because you need to estimate a depreciation factor this method is not so reliable when you are dealing with old buildings because it is difficult to prepare realistic estimates deleted depreciation

- the cost approach is normally better used in the appraisal of new buildings

- (1) estimate the market value of the land as if vacant or available for use

- (2) estimate the total cost to build the existing structure, using construction prices in effect on the date of valuation

- (3) estimate the appropriate amount to allow for accrued depreciation-meaning the loss in value of the subject building as compared to a new building

- (4) subtract the estimate depreciation from the cost of the hypothetical new structure, resulting in a depreciated cost estimate

- (5) had the value of the land to the depreciated replacement cost of the new structure. The result is the property value as reached by the cost approach

- see example 3.2 on page 52

### **The Income Approach**

- use this when you want to estimate the value of a property that produces income

- (1) obtain the annual rent schedules for the subject property and compare them with similar competition to arrive at a projection of reasonable gross rents for the subject property

- (2) estimate annual vacancy and collection losses

- (3) subtract these losses from the gross income to arrive at the effective gross income

- (4) estimate the annual operating expenses and subtract them from the effective gross income to arrive at the net income (or net operating income).

- (5) analyze comparable investments in order to arrive at a capitalization method and rate

- (6) capitalize the projected net income into an estimate of value

- see example 3.3 on page 54

- this is all just taste of the three methods, but we will look at much more in detail (sees it usually isn't quite as easy as this)