

15 Appraisal and Valuation

Property valuation may be considered the heart of all real estate activity. Only a practical understanding of real estate values will enable real estate brokers and salespersons to carry out their functions in a useful and dependable manner in serving their clients and in meeting their obligations to the general public.

Brokers and salespersons should have a good understanding of: the theoretical concepts of value; the forces which influence value; and the methods by which such value may be estimated most accurately.

Probably the question most frequently asked brokers by clients is, "How much do you think the property is worth?" It is a daily occurrence for the real estate broker to have clients ask about the fair price, fair rental, fair basis for trade, or a proper insurance coverage for property. A broker needs to know how to answer such questions correctly.

To be successful in business, an agent must determine whether time can profitably be spent in trying to sell property at a listing price set by the owner. The agent must keep in mind that in accepting a listing the agent is obligated to put forth best efforts to find a buyer for the property at that price. A seller's unrealistic asking price is a roadblock that can be remedied by a knowledgeable salesperson capable of making a market analysis and using the three approaches to value. Such ability assists the seller to set the most appropriate listing price.

The real estate professional is cautioned, however, not to claim greater appraisal ability or expertise than is actually possessed. Great harm can come to the client and to the professional if significant appraisal mistakes are made. When unable to competently perform a valuation, the advice of a professional real estate appraiser should be sought. Licensed or certified appraisers are governed in their competency by the Competency Rule in the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Foundation.

All licensed and certified appraisers in California must comply with USPAP in appraisal assignments.

THEORETICAL CONCEPTS OF VALUE AND DEFINITIONS

Definition of Appraisal

To appraise means the act or process of developing an opinion of value; an opinion of value. (USPAP, 2010-2011 Edition, pg. U-1) It may be said that value is the present worth of all rights to future benefits, arising out of property ownership, to typical users or investors. An appraisal report is usually a written statement of the appraiser's opinion of value of an adequately described property as of a specified date. It is a conclusion which results from the process of research and analysis of factual and relevant data.

Real estate appraising methods are being standardized by virtue of the experience and practice of qualified people in all parts of the country who encounter the same types of valuation problems, and who by various methods and processes succeed in solving them in an equitable manner. It is natural, however, that differences of opinion may exist as to the value of specific parcels of real estate and the means of estimating their value.

Property rights are measurable. Real estate as a tangible thing can be measured. It includes both land and improvements and exists independent of any desire for its possession. To distinguish between its physical aspects and rights in and to real property, the latter are called *property interests* in real estate.

These interests - ownership in fee simple and other lesser interests - have been discussed in preceding chapters.

Property rights in real estate are normally appraised at Market Value. There are many definitions of Market Value, but a good working definition is the most probable price the property would bring if freely offered on the open market with both a willing buyer and a willing seller.

Rights in real property are referred to as "Bundle of Rights," which infers: right to occupy and use; to sell in whole or in part; to bequeath (give away); and, to transfer by contract for a specific period of time (lease). It also implies the right not to take any of these actions.

These rights are limited by: the government's power of taxation; eminent domain; police power (for safety, health and general welfare of the public, such as zoning, building codes); and, right of property to escheat (revert) to the state in the event the owner dies and leaves no heirs.

The rights in a property must be known by the appraiser before making a proper valuation, and the appraiser must also be able to distinguish between personal and real property. Market value is the object of most appraisal assignments, and appraisals mainly are concerned with fee simple estate valuation as opposed to partial interest value.

The widespread need for appraisals is apparent. Everyone uses real estate in one way or another and must pay for its use, which involves a decision about value. Practical decisions concerning value must be based upon some kind of an appraisal or evaluation of real property collateral.

The term evaluation has a special meaning and use for institutional lenders since passage of the Federal Institutions Reform, Recovery, and Enforcement Act (FIRREA). In reality, it is an appraisal, an estimate of value.

Although an appraisal may be transmitted orally, it is usually a written statement of an opinion of value and is referred to as an *appraisal report*.

Traditional Approaches to Value

Basically, there are three approaches to property valuation used by appraisers. Each gives a separate indication of value, yet the approaches are all interrelated and all use market comparison techniques. All three approaches are considered in each complete assignment. However, all three are not always employed, depending upon the property type and the process and report type agreed to by the client and the appraiser.

The approaches to value are: Sales Comparison (or Market Data) Approach; Cost Approach; and Income Approach.

The Appraiser's Role in the Real Estate Profession

The licensed or certified appraiser, by reason of professional training, experience, and ethics is responsible for furnishing clients with an objective third party opinion of value, arrived at without pressures or prejudices from the parties involved with the property, such as an owner or lender.

The appraiser has a heavy personal and professional responsibility to be correct and accurate in opinions of value. Otherwise, the appraiser's clients may easily suffer loss and the appraiser's professional reputation may also suffer.

True forces affecting value. It is necessary that appraisers be exceptionally sensitive to their roles in accurately assessing the true forces affecting value. In accomplishing this, the appraiser cannot allow the general neighborhood composite of ethnic, religious, or minority populations or the general condition of neighborhood improvement to detract from a clear and objective evaluation of the property appraised on its own merits.

It is also the appraiser's responsibility to keep the appraisals timely in a changing market.

It is no longer prudent to rely solely on past sales of comparable property. The appraiser must use all pertinent data and appraisal methods to insure the appraised value is, in fact, the closest estimate of the price the property would bring if freely offered on the open market.

Recent world events has resulted in property appreciation spirals to historic highs, along with creative financing approaches to generate sales. This has been followed by a collapse in property values and extraordinary levels of foreclosure and bankruptcy. Such times required exceptional appraiser sensitivity to the true market forces.

The professional appraisal associations have responded with increased emphasis on education in current appraisal and financial techniques. The dynamics of such a volatile market require the appraiser to keep abreast of new techniques and market forces. Recognizing this, California statutes enforced by the Office Of Real Estate Appraisers (OREA) require continuing education for licensed and certified appraisers. Those requirements are set forth in the OREA portion at the end of this chapter.

Appraisal Report

An appraisal report sets forth the data, analysis and conclusions of the writer. When put in writing, it protects both appraiser and client. Reports vary in scope and length. The following information should be included and is more specifically outlined in Standards 1 and 2 of USPAP:

1. **A final value opinion** is expressed in terms of dollars for the property which is being appraised.
2. **The value opinion** can be made for any date in the past, and, with some care, for any date in the future. The time of inspection of the physical improvements is generally taken as the effective date of value unless otherwise informed by either the property owner, owner's attorney, or a court of law. The date of the final writing and delivery of the report is the date of the appraisal, not to be confused with the effective date of value.
3. **Adequate description of the property.** The street address, including city and state, as well as a complete legal description as set forth by the deed in the County Recorder's Office, should be shown, and the physical structures should be clearly described. The length of this description will depend upon the length and extent of the report.
4. The **latitude of the reasoning** in determining the *value opinion* will depend upon the type of report and the complexity of the appraisal problem.
5. **Market data, and other factual data.** This includes information on the city and neighborhood which affects the *value opinion*; information gathered on the site, improvements and the environment of the neighborhood which should be processed by means of one or more of the approaches to value; and, the preliminary estimate of value should be reconciled by means of logic and reasoning in order to arrive at one *value conclusion* for the property. Lengthy details are usually omitted in letter reports, but appraiser retains the information as backup in a work file.
6. **Signature and certification.** Appraisal reports must be signed by the writer, include the license number, and in most instances are preceded by a statement to the effect that the writer has no present or contemplated interest in the property. Requisites of an appraisal are set forth in the USPAP, which was adopted in 1989 by the Appraisal Standards Board of the Appraisal Foundation.

Types of Appraisal Reports (and USPAP Terminology)

1. **Letter report.** This type of report is generally used when the client is familiar with the area, and the reporting of supporting data are not necessary. The report consists of a brief description of the property, the type of value sought, the purpose served by the appraisal, the date of value, the value opinion and the signature of the appraiser. This is known as a Restricted Use Report and is governed by Standards Rule 2-2(c) of the USPAP. Specific language is required to put readers on notice that this report type is for use by the client only with restrictions.
2. **Form report.** To ensure uniformity in the underwriting of loans, common property types have standardized form reports. Examples of form reports include the Uniform Residential Appraisal Report (URAR) and the Small Residential Income Property Appraisal Report (SRIPAR). This type of report is normally used by lending institutions, such as banks, insurance companies, saving and loan associations, and governmental agencies. Generally, it consists of simple check sheets or spaces to be filled in by the appraiser. The report varies from two to eight pages in length and includes the pertinent data about the property, with photos, maps, plats and sketches. Today these types of reports are classified as Summary Reports and are governed by Standards Rule 2-2(b) of USPAP. This category of report can also be a narrative format, but the data presented will be generally in a summary format with more information than a restricted report.
3. **Narrative report.** This type of report can be a complete document including all pertinent information about the area and the subject property as well as the reasons and computations for the *value conclusion*. It includes: maps, photographs, charts and plot plans. It is written for court cases and out-of-town clients who need all of the factual data. It gives the comprehensive reasoning of the *appraiser* as well as the *value opinions*. These reports are often classified as Self-Contained Reports, which are governed by Standards Rule 2-2(a) of USPAP. Narrative reports can also be prepared in a summary format, which are regulated by Standards Rule 2-2(b) in USPAP.

Any of these report types could be done on a form or in a narrative format. The contents and the depth of discussion, not the format, define the report type in USPAP terms.

Purposes and Uses of Appraisals

The basic purpose of an appraisal is to estimate a particular value, i.e., market value, check for support of sales price, loan value, investment value, etc. Some of the uses for requiring the estimate of value are:

1. *Transfer of ownership of property.*
 - a. An appraisal assists buyers and sellers in arriving at a fair and equitable sales price. An appraisal of physical property may also include an opinion of its age, remaining life, quality or authenticity.
 - b. The listing agent needs an estimate of value of the property before accepting a listing from the owner. If the agent can show by means of an appraisal the appraised market value of the property, and obtain a listing at that figure, a sale more likely will result. The real estate practitioner should be prepared to demonstrate a knowledge of both comparative and economic values.
 - c. Where a trade is involved, appraisals tend to assist in clarifying the opinions of value formed by both parties to the trade.
 - d. Valuations are necessary for the distribution of estate properties among heirs.
2. *Financing and credit.*
 - a. The lender has an appraisal made of the value of the property to be pledged as security for a mortgage loan.
 - b. Measuring economic soundness of real estate projects involves feasibility studies in relation to financing and credit.
3. *Appraisal for taxation purposes.*
 - a. Appraisals are needed by governmental bodies to establish the proper relationship between land and improvements for real estate taxes (ad valorem taxation).
 - b. Properties subject to estate taxes must be evaluated for the purpose of levying federal and state taxes.
 - c. Appraisals of income-producing properties are necessary to property owners for the basis of depreciation. Normally, only improvements can be depreciated, not the land. An allocation of the market value between land and improvements is a requisite for accounting and taxation purposes.
4. *Condemnation actions.*
 - a. With the right of eminent domain being vested in governmental agencies, it is important that properties under condemnation be evaluated at market value to properly estimate purchase price, benefits, and damages to the property being affected.
5. *Insurance Purposes.*
 - a. Appraisals are based principally upon the cost of replacement. This is important for the purpose of insuring properties for fire insurance.
 - b. Appraisals are useful in setting claims arising from insurance contracts after a property has been destroyed.
6. *Miscellaneous reasons for appraisals.*
 - a. Catastrophic damage. Establishing market value of property before and immediately after the damage.
 - b. Estimating market rents for negotiation of leases.
 - c. Appraisals for inheritance and gift tax purposes.
 - d. Fraud cases.
 - e. Damage cases.
 - f. Division-of-estate cases. A distribution of property under the terms of a will, in divorce proceedings, or between rival claimants, frequently requires that the value of the property involved be determined by appraisal.

PRINCIPLES OF VALUATION

A knowledge of basic assumptions, postulates or premises that underlie appraisal methods is essential to an understanding of the purpose, methods and procedures of valuation. The following principles of value influences are the more important for a general understanding of the appraisal process.

Principle of conformity. Holds that maximum value is realized when land uses are compatible and a reasonable degree of architectural harmony is present. Zoning ordinances help set conformity standards.

Principle of change. Real property is in a constant state of flux and change, affecting individual properties, neighborhoods and cities. The appraiser follows trends and influences and is sensitive to changes in conditions that affect the value of real estate. Economic, environmental, government, and social forces affect all markets, especially real estate.

Principle of substitution. This principle is the basis of the appraisal process. Simply stated, value will tend to be set by the cost of acquiring an equally desirable substitute. The value of a property to its owner cannot ordinarily exceed the value in the market to persons generally, when it can be substituted without undue expense or serious delay. In a free market, the buyer can be expected to pay no more, and a seller can expect to receive no less, than the price of an equivalent substitute.

A property owner states that owner's house is worth \$95,000. Buyers in the market can obtain a substitute property with the same features and utility for only \$90,000. The seller's house, therefore, has a value of approximately \$90,000, not \$95,000.

Principle of supply and demand. Holds that price varies directly, but not necessarily proportionately, with demand, and inversely, but not necessarily proportionately, with supply. Increasing supply or decreasing demand tends to reduce price in the market. The opposite is also true.

Principle of highest and best use. The best use of a parcel of land, known as its highest, best and most profitable use, is that which will most likely produce the greatest net return to the land over a given period of time. This net return is realized in terms of money or other amenities.

The application of this principle is flexible. It reflects the appraiser's opinion of the best use for the property as of the date of his appraisal. At one period of time, the highest and best use of a parcel of land in a downtown business district might be for the development of an office building; at another time, a parking lot may be the highest and best use.

A single-family house on a commercial lot may not be the highest and best use for the site. A four-unit apartment on multiple zoned land suitable for 30 units is probably not the long-term highest and best use of the land.

The appraiser applies four accepted tests in arriving at the highest and best use for a property. The use must be (1) Legally permissible; (2) Physically possible; (3) Economically feasible; and (4) The most productive use.

There may be two highest and best uses, one with the site vacant and the other as improved. These must be reconciled into a final highest and best use determination for the property being appraised.

Determining highest and best use includes assessing potential buyers' motives, the existing use of the property, potential benefits of ownership, the market's behavior, community or environmental factors, and special conditions or situations which come to bear on appraisal conclusions of value.

Principle of progression. The worth of a lesser-valued object tends to be enhanced by association with many similar objects of greater value (inadequacy or under-improvement).

Principle of regression. The worth of a greater-valued object is reduced by association with many lesser-valued objects of the same type (super adequacy or over-improvement).

Principle of contribution. A component part of a property is valued in proportion to its contribution to the value of the whole property or by how much that part's absence detracts from the value of the whole. Maximum values are achieved when the improvements on a site produce the highest (net) return, commensurate with the investment.

Principle of anticipation. Value is created by anticipated future benefits to be derived from the property. In the Market Value Analysis, appraisers estimate the present worth of future benefits. This is the basis for the income approach to value. Simply stated, the income approach is the analysis of the present worth of projected future net income and anticipated future resale value. Historical data are relevant because they aid in the interpretation of future benefits.

Principle of competition. Competition is created where substantial profits are being made. If there is a profitable demand for residential construction, competition among builders will become very apparent. This could lead to an increase in supply in relation to the demand, resulting in lower selling prices and unprofitable competition, leading to renewed decline in supply.

Principle of balance. Value is created and sustained when contrasting, opposing, or interacting elements are in equilibrium, or balance. Proper mix of varying land uses creates value. Imbalance is created by an *over-improvement* or an *under-improvement*. Balance is created by developing the site to its highest and best use.

Principle of four-stage life cycle. In due course, all material things go through the process of wearing or wasting away and eventually disintegrating. All property is characterized by four distinct stages: *growth, stability, decline, and revitalization*.

Single properties, districts, neighborhoods, etc., tend generally to follow this pattern of growth and decline. It is also evident this process is frequently reversed as neighborhoods and individual properties in older residential areas are renewed and restored.

Revitalization and modernization in inner-city older neighborhoods may result from organized government programs or as a result of changing preferences of individual buyers. Most neighborhoods remain in the mature or stable stage for many years, with decline being hardly noticeable as renewal becomes essentially an ongoing process.

BASIC VALUATION DEFINITIONS

Value Designations

There are many different designations or definitions of value. They may be divided into the following two main classifications:

Utility Value, which is value directed toward a particular use. This frequently is termed *subjective* value and includes valuation of amenities which attach to a property or a determination of value for a specified purpose or for a specific person.

Market value, which represents the amount in money (cash or the equivalent) for which a property can be sold or exchanged in prevailing market conditions at a given time or place as a result of market balancing. It may be based on a “willing buyer” and “willing seller” concept. This is frequently termed the *objective* value, since it is not subject to restrictions of a given project.

Appraisers carefully define the value being sought. Types of values include Liquidation Value, Market Value, Investment Value and, of course, Assessed Value (for taxation).

The real estate market sometimes places great importance on real estate financing terms. Market Value might be estimated for specific financing arrangements: seller carry-back, balloon payments, renegotiable mortgages or other “creative” financing techniques.

Market Value Defined

In appraisal practice, the term Market Value is defined by agencies that regulate federal financial institutions in the U.S. That definition is given as:

“The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus.”

Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated;
2. buyer and seller are well informed or well advised and acting in what they consider their own best interest;
3. a reasonable time is allowed for exposure in the open market;
4. payment is made in terms of cash in United States dollars or terms of financial arrangements comparable thereto; and
5. the price represents the normal consideration for the property sold, unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(Source: *Uniform Standards of Professional Appraisal Practice*, Appraisal Foundation, 2010-2011 Edition, page A-105.)

Fair Market Value Defined

Courts and accounting practice sometimes require “fair market value” opinions. The legal definition of Fair Market Value under California law is found in the Code of Civil Procedure, Section 1263.320, as follows:

“The fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available. The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.”

Cost and Price in Relation to Value

Appraisers carefully distinguish between their defined value, cost and price in refining their appraisal opinions.

Cost is defined in USPAP as follows: “The amount required to create, produce, or obtain a property.” USPAP notes that cost is either a fact or an estimate of fact.

Price is defined in USPAP as follows: “The amount asked, offered, or paid for a property.” USPAP notes that “Once stated, price is a fact, whether publicly disclosed or retained in private. Because of the financial capabilities, motivations, or special interests of a given buyer or seller, the price paid for a property may or may not have any relation to the value that might be ascribed to that property by others.”

Value is defined in USPAP as follows: “The monetary relationship between properties and those who buy, sell, or use those properties.” USPAP notes that “Value expresses an economic concept. As such, it is never a fact, but always an opinion of the worth of a property at a given time in accordance with a specific opinion of value. In appraisal practice, value must always be qualified – for example, market value, liquidation value, or investment value.”

Generally speaking, a broker or salesperson will focus on price. Examples include list price, offer price, contract price, and broker’s price opinion (BPO). Those providing a service or product normally speak in terms of cost. Appraisers will consider prices and costs in the valuation process when developing a value opinion

Purposes and Characteristics of Value

The purpose of a valuation or an appraisal is usually indicated in the value concept employed, for example: market value, assessed value, condemnation value, liquidation value, cash value, mortgage loan value, fire insurance value, etc. The purpose of an appraisal frequently dictates the valuation method employed and influences the resulting estimate of value.

Intended use and intended user(s) of the appraisal report. Appraisers are required to identify the intended use and intended user(s) of the appraisal assignment. The intended use and intended user(s) of the report have become distinct from the purpose of the appraisal. This relates to how the process has been separated from the writing of the report (Standard 1 vs. Standard 2 in USPAP). The purpose of the appraisal may be, for instance, to help in settling an estate. The intended use of the report may be to communicate the value findings to heirs only, or may include attorneys and/or taxing authorities. The purpose helps to define how the appraisal process will be laid out. The identification of the intended use and intended user(s) will help to determine which report type is most appropriate for communicating the results of the process.

Appraisal Client. USPAP defines the client as follows: “The party or parties who engage an appraiser (by employment or contract) in a specific assignment.” USPAP further comments on the client: “The client identified by the appraiser in appraisal, appraisal review, or appraisal consulting assignment (or in the assignment workfile) is the party or parties with who the appraiser has an appraiser-client relationship in the related assignment, and may be an individual, group, or entity.

Confidentiality. The Confidentiality Section of the Ethics Rule in USPAP states that the appraiser must protect the confidential nature of the appraiser-client relationship. This is significant because the appraiser must not disclose confidential information in the report or the assignment results to anyone other than the client or persons authorized by the client. Note that the state appraiser regulatory agencies and third parties duly authorized by law are also authorized to obtain the confidential information found in an appraisal report. This prohibits the appraiser from discussing assignment results or providing copies of the appraisal reports to agents or borrowers unless they are the client identified in the appraisal report.

Four elements of value. There are four elements of value, all of which are essential. These are utility, scarcity, demand (together with financial ability to purchase), and transferability. None alone will create value, but all must be present to achieve value for a property. For example, a thing may be scarce but, if it has no utility, there is no demand for it. Other things, like air, may have utility and may be in great demand, but are so abundant as to have no commercial value. *Utility* is the capacity of a commodity to satisfy a need or desire. To have utility value, real estate should have the ability to provide shelter, income, amenities or whatever use is being sought. Functional utility is an important test for determining value. Likewise, the commodity must be transferable as to use or title to be marketable.

Generally speaking, a commodity will have commercial or marketable value in proportion to its utility and relative scarcity. Scarcity is the present or anticipated supply of a product in relation to the demand for it. Utility creates demand, but demand, to be effective, must be implemented by purchasing power. Otherwise, a person desiring a product cannot acquire it.

Real estate cycles cause fluctuations in the four elements of value. For example, when interest rates increase, fewer buyers are able to qualify for loans. This in turn reduces demand for real estate. This may lead to an over-supply of properties for sale (or a lack of scarcity).

FORCES INFLUENCING VALUE

The value of real estate is created, maintained, modified and destroyed by the interplay of the following four great forces:

1. **Environmental and physical characteristics.** Examples of physical characteristics include: quality of conveniences; availability of schools, shopping, public transportation, churches; similarity of land used; and types of physical hazards. Environmental considerations include climate, soil and topography, barriers to future development (oceans, mountains, etc.), transportation systems, and access to other areas/regions.
2. **Social ideals and standards.** Examples of social forces include: population growth and decline; age, marriage, birth, divorce and death rates; and attitudes toward education, recreation, and other instincts and yearnings of mankind.
3. **Economic influences.** Examples of economic forces are: natural resources; industrial and commercial trends; employment trends; wage levels; availability of money and credit; interest rates; price levels; tax loads; regional and community present economic base; new development trends; and rental and price patterns.
4. **Political or government regulations.** Examples of political forces include: building codes; zoning laws; public health measures; fire regulations; rent controls; environmental legislation controlling types of new development; fiscal policies; monetary policies; government guaranteed loans; government housing; and credit controls.

Each and every one of these many physical, social, economic and political factors affect cost, price, and value to some degree. The four forces interweave and each one is in a constant state of change.

Factors Influencing Value

Directional growth. In any estimate of value, attention should be given to “the city directional growth” as well as to “Urban Renewal Plans.” The city directional growth refers to the manner and direction in which the city tends to expand.

Properties in the direction of growth or renewal in different sections of the city tend to increase in value, especially if the growth or renewal is steady and rapid.

Location. Location is an exceptionally important value factor because location influences demand for the property. Location must not be described too generally, and is an effective value factor only when it is specifically related to highest and best use. Brokers often claim, “The three most important characteristics for any property are location, location and location.”

Utility. Utility includes the capacity to produce. Another word for utility is “usefulness.” This important factor involves judgment as to the best use to which a given property may be put. Building restrictions and zoning ordinances affect utility.

Size. The width and depth of a parcel of land will often determine the possibilities and character of its use.

Corner influence. Corner sites sometimes have higher unit value than a site fronting on one street only. Disadvantages include loss of privacy, higher cost as off-site improvements cost more and lot maintenance is more expensive, and setbacks may require a smaller size house. Commercial properties benefit from corner sites because of easy access and added exposure.

Shape. Parcels of land of irregular shape generally cannot be developed as advantageously as rectangular lots.

Thoroughfare conditions. The width of streets, traffic congestion, and condition of pavement have an effect on the value of frontage properties and to a lesser degree on other properties in the neighborhood. Highly trafficked streets are conducive to value for commercial properties but negatively affect value for residential uses.

Exposure. The south and west sides of business streets are usually preferred by merchants because pedestrians seek the shady side of the street on warm afternoons and merchandise displayed in the windows is not damaged by the sun. This traditional view in older commercial districts is somewhat offset by new architectural concepts (e.g., shopping malls), parking and convenience.

Character of business climate. Larger cities develop residential, shopping, financial, wholesale, and industrial districts.

Plottage or assemblage. An added increment of value when several parcels of land are combined under one ownership to produce greater utility than when the parcels are under separate ownership.

In highly urbanized multiple residential and commercial areas plottage, or assemblage, makes it possible to gain that higher utility. An example of this would be a density bonus for the combining of residential lots. This principle may also apply to light industrial areas.

Topography and character of soil. The bearing qualities of the soil may affect construction costs. Extensive foundations are usually necessary in soft earth. The type and condition of the topsoil affect the growth of grass, plants, shrubs and trees. Value may also be influenced by land contour and grades, drainage and view points.

Obsolescence. Appraisers consider two types of obsolescence: functional and external. External obsolescence is caused by external factors or economic changes outside the boundaries of a property. External obsolescence is not curable.

Functional obsolescence is caused by either a deficiency or a superadequacy. An example of a superadequacy, or over-improvement, would be a swimming pool that costs \$60,000 to construct while the market is only willing to pay \$10,000 for the pool. Functional obsolescence is categorized as curable or incurable. Curable functional obsolescence will provide a positive return if repaired. This occurs when it costs less to correct the deficiency than the market is willing to pay for it. An example would be the replacement of a heating system that would cost \$3,000 when the market is willing to pay \$10,000 for a home with the new system. Incurable functional obsolescence occurs when it would cost more to correct a deficiency than the market is willing to pay

for the correction. Changes in types and methods of construction, style of architecture, or interior arrangements for specific purposes may render a particular building out of date. Changes in the uses of neighboring property may also contribute to the obsolescence of a building. Careful appraisal will consider the potential for remodeling, refurbishing or other method to restore value.

Building restrictions and zones. These sometimes operate to depress values and at other times to increase values.

For example, there may be a vacant lot on a residential street which will sell for only \$150 a front foot for single family residential use but would sell for \$600 per front foot as an apartment site. Or a vacant lot in a zoned area may sell for more per front foot as a business site because of the supply of business sites being restricted by zoning.

Tract layouts. In the study and valuation of unimproved but potentially valuable industrial lands, it is often necessary to have the assistance of a competent engineer who is familiar with plant and tract layouts.

Additional Factors Important for Agricultural or Farm Lands

Present trends show larger and fewer farms, fewer farm buildings per acre, and fewer family-style operations. The type of buildings an appraiser usually finds on agricultural lands include residences, machine sheds, poultry sheds, multifunctional barns, silos, and various animal shelters. According to some experts in the field, farm buildings contribute less than 20% of the total property value.

One important factor in estimating the value of agricultural land is the nature and long-term trend of costs and prices for the crop grown or intended to be grown. For example, if the property is to be used as a dairy farm the appraiser must consider: whether the soil is suitable for hay and grain; water supply for the cattle and crops; proximity to markets; climatic conditions; labor conditions, etc.

Farm land valuation is highly specialized and often requires the assistance of soil and crop experts and appraisal specialists to evaluate irrigation systems and other equipment and machinery.

ECONOMIC TRENDS AFFECTING REAL ESTATE VALUE

Regional, National and Global Economics

Property values increase, decrease, or remain stable based on the interaction of the four forces influencing value. Appraisers must examine and evaluate these forces.

Economic trends and forces at higher levels (regional, national and international) affect property values at the local level. The real estate appraiser must recognize that the general pattern of statistical analysis that guides in interpreting value influences on a national level should be used in the general analysis of state and regional forces which in turn influence local property values.

An appraiser should follow national and regional economic trends, changes in national income levels, international developments and government financing policies because as recent events have shown the greater the severity and duration of any economic swing, the wider and deeper is its influence. Conditions to be observed include: gross national product; balance of payments to other countries; national income levels; employment; price level indexes; interest rates; fiscal and monetary policies; building starts; and credit availability.

Factors Influencing City Growth and Development

An appraiser is constantly concerned with the conditions and prospects of the local economy because the value of local real estate is largely determined by the health of the community, as measured by household purchasing power, population changes, employment diversification and stability, wage and price levels, and area growth potential, including environmental conditions.

Cities are classified generally by the functions that stimulate and determine their potential and growth. These classifications are:

Commercial. Primary source of revenue stems from commercial enterprises. These are usually farming cities, cities located at railroad terminals or on ocean ports.

Industrial. Primary source of revenue is derived from manufacturing and processing of commodities.

Extractive industry. Primary source of revenue comes from natural resources, e.g., mining, fishing and lumber.

Political. Primary source of revenue is government employment.

Recreation and health. Primary source of revenue comes from tourist trade, vacation and health resorts.

Education. The anchor point of these cities is a college or university.

Population Trends

Because of the direct relationship existing between the value of real property and population growth, the appraiser should be concerned with population trends and other demographic factors affecting local population, such as: opportunities for employment; quality of local government; civic and social conditions; demand for goods and services; transportation and living conditions; and, opportunities for education and personal improvement.

Neighborhood Analysis

A neighborhood may be defined as a group of similar land uses which are similarly affected by the operation of the four forces influencing value: utility, scarcity, demand(desire) and transferability. A common definition for a neighborhood is a grouping together of individuals within the community for similar purposes and interests, whether the reasons be commercial, industrial, residential, cultural or civic. The life cycle of a neighborhood includes growth in desirability, peak desirability, stability for a time, then deterioration. The cycle then tends to turn again as the neighborhood becomes more desirable due to change in use or renewal.

Neighborhood analysis is important because the neighborhood is the setting for the property to be appraised and the property has value, to a large extent, as it contributes to or detracts from the neighborhood.

A neighborhood tends to be a somewhat self-contained community, frequently defined by physical boundaries such as hills, freeways, or major streets and usually with some sense of community. In urban areas, the neighborhood tends to become somewhat blurred due to modern transportation and area-wide cultural, educational, recreational, and commercial services. In analyzing the “neighborhood” of the parcel to be appraised, a good starting point is to ascertain the community identity and boundaries.

After defining, even in vague terms, this community identity, an appraiser will look to common services and features, such as local shopping, street patterns, zoning boundaries, and cultural, religious, educational and recreational services. In short, an appraiser searches the local area by observation and through government and public utility investigation to find the factors most affecting use and value patterns in the area.

Neighborhood analysis also tends to define the best search area for comparable market data. As the appraisal progresses, the appraiser may extend or contract this search area.

Some sources of neighborhood data:

1. U.S. Census tract maps and data (local library or vendors).
2. City and county population demographics (planning departments).
3. City, county, and state street and highway systems (city, county and state road/engineering/highway departments).
4. Local zoning and general planning, including community plans (planning departments).
5. School locations, capacities, policies (local school districts).
6. Public utility services: water, sewer, natural gas, electric power, telephone (local public utility companies and government agencies).
7. City and county economic statistics (local chambers of commerce).
8. Local tax information (county tax assessor).
9. If pertinent, private wells and septic laws (local health departments); national forest/park laws (local forestry and park dept.), etc.

SITE ANALYSIS AND VALUATION

Although the location of the neighborhood and city must be weighed in analysis and valuation of a particular site, the location of the site itself, in relation to the neighborhood, is a very important factor.

Since sites in a neighborhood are not usually uniform in size, shape and other physical and economic characteristics, some are superior to others. It is important that the site be analyzed separately and evaluated in conformity with the principle of highest and best use.

Appraisers value the site when there are no improvements on the property. Appraisers also at times will value a site separately from improvements that may be on the site. Examples of those times where an appraiser would value the site separately from improvements include the cost approach, income approach, and property tax valuation.

Other reasons to separate the land from the value of an entire property, along with important factors contributing to site value, are discussed on the following pages.

Legal Data of Site Analysis**A. Legal description.**

1. An appraiser must determine the legal property description as set forth by a deed or official record.
2. The proper legal description helps to locate the property physically within the neighborhood.

B. Taxes.

1. A comparison is made between the subject and similar properties to ascertain if the property being appraised has been fairly assessed (assessed value, tax rate and tax total). This comparison of properties is not as useful since the adoption of Proposition 13. After declining real estate cycles occur, many property owners engage appraisers to render value opinions that lead to reassessment for lower property taxes.
2. The extent of the tax burden will have a bearing upon the desirability of the property, particularly when taxes are out of proportion to income.

C. Zoning and General Plan.

1. Copies of the latest zoning ordinances and general plan should be studied to inform the appraiser as to the present usages to which the land may be developed. Sometimes the highest and best use of land is limited by zoning restrictions.
2. Proposed or contemplated changes in the existing ordinances should be determined, since this could have a bearing upon the valuation of the property. However, zoning by itself does not create value unless there is a demand for the land so zoned.

D. Restrictions and easements.

1. Public and private restrictions and easements affecting the land must be discovered.
2. The restrictions and the types of easements on the property have a direct bearing upon the use and value of the site being appraised.

E. Determination of existence of other interests in property.

1. Life estates.
2. Leases.
3. These partial interests divide property values among the parties involved. This does not mean a mathematical division, but rather a division of the bundle of rights.

Physical Factors Involving the Site**A. The physical features of the site should be compared with typical lots in the neighborhood.****B. Lot values will generally tend to cluster around a "site value,"... the price generally accorded a single, usable, typically-sized parcel of land in the area. Lots larger or smaller will tend to increase or decrease**

when compared to this usual “site value.” A good view will also tend to increase lot value. The effect of topography (drainage, low spots, rock, etc.) can frequently be measured by the cost to cure the problem to make the site usable.

- C. Shape of a lot.
 - 1. The utility of the lot is the governing factor in irregular or odd-shaped lots.
 - 2. The total area of the lot is not the most important factor. A 50' x 150' lot containing 7,500 square feet is more valuable than a 25' x 300' lot (also 7,500 sq. ft.) because of utility.
 - 3. Irregular-shaped lots are frequently valued in terms of total site value expressed in dollars rather than in terms of unit values of price per square foot or frontage foot.
- D. Topography and soil conditions.
 - 1. The topography and the type of soil can have an adverse effect upon the site value if it makes building costs higher.
- E. Corner influence.
 - 1. In today's market, it has generally been found that corner single-family lots are not valued appreciably more than inside lots.
 - 2. Corner lots provide better light and more convenient access.
 - 3. On the other hand, corner lots result in more traffic noise and trespassing and, if applicable, greater special assessments for streets and lighting.
- F. Relation of site to surroundings.
 - 1. The site must be studied in its relationship to streets, alleys, transportation, and stores.
 - 2. Does the homesite abut commercial or multi-residential uses?
 - 3. Is it a key lot looking upon other back yards?
 - 4. If a corner lot, does a bus line stop at the corner?
 - 5. Are there high tension power lines over the site?
 - 6. Is the site in an airport flight pattern?
- G. Availability of public utilities.
- H. Title encumbrances and encroachments.
- I. Landscaping and underground utilities.

Methods of Site Valuation

- A. Sales or market data comparison.
 - 1. Sales and listings (data) of vacant sites are obtained and compared with the property being valued.
 - 2. The data should be of comparable properties, including the same zoning and in the same or similar neighborhood. Since people make value, the data gathered should be from areas where the purchasing power or income levels are the same as the subject property.
 - 3. The sales prices should be investigated to determine whether the price paid was the result of a true open market transaction reflecting market value. Listings may also be considered.
 - 4. Some sources of comparable market data are:
 - a. Title insurance company records.
 - b. Tax assessor's records.
 - c. Recorder's office.
 - d. Multiple listing files.
 - e. Financial news.
 - f. Appraiser's personal files.
 - 5. The verified market transactions should be compared with the subject parcel as to:

- a. Time.
 - (1) Determine if prices have gone up, down, or remained stable from the time of each sale to the date of value.
 - (2) A percentage factor or a dollar amount may be applied to the comparable sales in order to arrive at an adjusted price due to the time factor.
- b. Location.
 - (1) Determine if the location of each comparable property is superior, equal or inferior to that of the subject property.
 - (2) A percentage factor or dollar amount may be applied to the data in order to adjust for the difference in location.
- c. Characteristics of the lots.
 - (1) The size, depth, shape, topography, soil conditions, utility improvements, and the other measurable characteristics of the other properties are compared with the property being valued.
 - (2) A percentage factor or dollar amount is determined for these characteristics and applied to the comparable properties to adjust their prices towards the property being appraised.
- d. The adjusted prices of the comparable properties are then compared and analyzed in order to arrive at an estimate of value for the property under study.

Example. Using only 3 lot sales (the minimum) as a demonstration.

<i>Sale No.</i>	<i>Price</i>	<i>Date</i>	<i>Size (feet)</i>	<i>Square Feet</i>
1	\$5,000	January	50 x 120	6,000
2	\$4,750	June	40 x 130	5,200
3	\$5,500	September	50 x 120	6,000
Subject		September	50 x 150	7,500

Through investigation, it was found that prices have been increasing approximately 1% a month during the past year.

Sale No. 1 is believed to be located in an area inferior to the subject. This lot would sell for about \$500 more if located in the subject's block. Sale No. 2 is located in an area believed to be about \$250 better than the subject. Sale No. 3 is also in a superior location, by the same \$250 adjustment.

The shape and topography of Sales No. 1 and No. 2 are better than the subject by an amount estimated to be \$500 and \$100 respectively. Sale No. 3's topography and utility appear about the same as the subject.

Adjustments.

<i>Sale No.</i>	<i>Time</i>	<i>Location</i>	<i>Characteristics</i>	<i>Adjusted \$</i>	<i>Adj. \$/sq. ft.</i>
1	+\$500	+\$500	-\$500	\$5,500	\$.92
2	+\$240	-\$250	-\$100	\$4,640	\$.89
3	+\$110	-\$250	0	\$5,360	\$.89

The average adjusted price per square foot of the comparable sales is \$.90. Therefore, the subject property has an indicated value as follows:

$$7,500 \text{ square feet} \times \$.90 \text{ per square foot} = \$6,750.$$

In actual practice, the use of more sales data is advisable in order to arrive at a well-supported adjusted price per square foot.

- e. If all pertinent factors are considered, the adjusted prices will probably be in a fairly close range. If there is still a wide discrepancy, the appraiser will:
 - (1) re-analyze work to find undisclosed pertinent factors;
 - (2) reexamine data as being true examples of market transactions;
 - (3) recompute adjustments to insure accuracy; and
 - (4) finally, discard the data or explain the apparent contradictions.

B. Abstraction.

- 1. The abstraction method is used to obtain land value where there are no vacant land sales.
 - a. Sales of houses in the same neighborhood on lots with similar characteristics are obtained.
 - b. An estimate of the cost new of the improvements is made.
 - c. An amount is deducted from cost new for depreciation.
 - d. The depreciated cost of the improvements is deducted from the selling price of the property.
 - e. The difference represents an approximation of land value.
- 2. **Example:** Appraised lot size is 65' X 100' = 6,500 sq.ft. Sale property is 6,000 sq. ft. lot with a single family residence and sold for \$83,000. The sale building has an estimated cost new of \$61,000 and an accrued depreciation estimated at \$20,000. Land value by abstraction:

Price of sale property	\$83,000
Less depreciated value of improvements:	
Cost new	\$61,000
Less accrued depreciation	<u>\$20,000</u>
Depreciated value	<u>\$41,000</u>
Indicated land value	\$42,000
Divide by lot size	÷ 6000 sq.ft.
Indicated lot value/sq.ft.	\$7.00/sq.ft.
Multiply by subject lot size:	
65' x 100' = 6,500 sq.ft.	<u>x 6,500</u>
Indicated value of lot	\$45,500

Plot Plan. For better appraisal reporting, a plot plan can be prepared, with lot dimensions and improvements drawn to scale. It should show walks, driveways and other lot improvements and roof plans of the various structures on the site. The plot, together with pictures of the site, neighboring street and lot improvements are vital for an effective site analysis.

ARCHITECTURAL STYLES AND FUNCTIONAL UTILITY

It is essential for an appraiser to have a working knowledge of building design and construction. Good basic design of both interior and exterior has a decided effect on the marketability of real estate. There is no substitute for appropriate materials and proper proportions and scale. The appraiser should be aware of imitations and new plastic replacements.

To achieve maximum value, architectural style and design should be related to the site. A typical stable neighborhood should be improved with homes of approximately the same size, age and style. A house that has an architectural style extremely foreign to its surroundings tends to encounter difficulty when offered for sale.

Or a home meets resistance in the market because of its style, which places it within a definite age group. Thus, if a certain style of architecture has lost its appeal because public taste has changed, this trend will have an adverse effect on value. Both real estate brokers and appraisers must be familiar with home styles and know the effect on value of misplaced styles. The appraiser must also be alert to resurgence of older properties in public acceptance.

This section: contains brief descriptions of various architectural styles in single family homes; explains how to determine quality of construction; and defines functional utility and its effect on marketability.

Architectural Styles

Colonial. Cape Cod and Cape Ann styles are: generally quite small in size - minimum with good taste; symmetrical-windows balanced on both sides of front door; either one or one and one-half stories with little head room upstairs; fairly steep gable or gambrel roof covered with wood shingles; and exterior of wood siding.

New England Colonial. A square or rectangular, box-like structure having: maximum usable space; symmetrical windows balanced on both sides of front door; either two or two and one-half stories; gable roof covered with wood shingles; exterior of wood generally painted white; and impressive front entrance usually with transom fan of glass above the door.

Dutch Colonial. A moderate-sized home generally not more than 50 feet wide, with a symmetrical front having: an entrance at the center, balanced by the windows; low-sweeping gambrel roof; exterior generally of stone; and either one and one-half story with dormer windows or two and one-half stories with dormer windows.

Georgian and Southern Colonial. These styles have elaborate front entrances with plain or fluted columns; are generally of brick or wood; have prominent gabled roofs, often hipped; are very symmetrical; require large plots of land; large scale, not suitable for a small house; and either two, two and one-half or three stories.

English Elizabethan. This style has gothic refined lines with molded stone around windows and doors; generally of brick, stucco, or stone; steep pitched roof, covered with slate or shingle; usually leaded metal casement windows; and requires a large building site.

English Half-Timber. This style has protruding timber faces with stucco between the faces; lower story of heavy masonry; steep pitched roof; generally two stories; and requires a large lot area.

Regency. A generally symmetrical style with front entrance in center; exterior of brick or stone; shutters on each side of windows; low hipped roof; two stories in height; and octagonal window on second floor over front door.

French Provincial. Usually a large house on a sizable plot, masonry exterior walls with very high roofs; large high windows with long shutters; and one and one-half or two and one-half stories.

French Normandy. Generally has turrets at entry; walls of brick or stone; unsymmetrical; and steep pitched shingle roof.

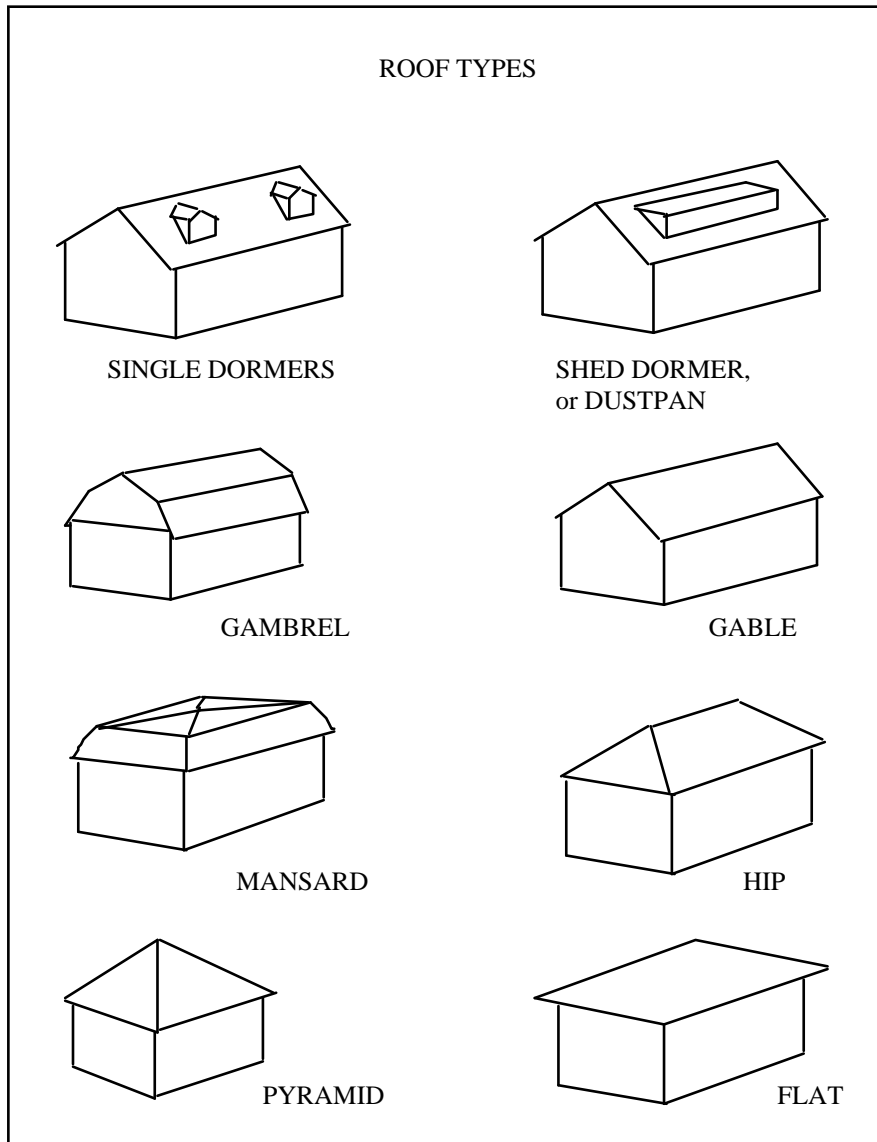
True Spanish. Enclosed patios; red mission tiled roof; wrought iron decorations; and stucco walls (usually white).

Small California Spanish. Stucco exterior; flat composition roof with mission tile trim in the front; suitable for small lots; no patio; and one story only.

Monterey Spanish. Two stories; stucco (generally white); red mission tiled roof; second story balconies; and decorative iron railings.

Modern and Contemporary. Generally one story; usually flat or low pitched roof; often on concrete slab; large amount of glass; and indoor/outdoor living.

California Bungalow or Ranch House. One story; stucco with wood trim; often on concrete slab; shingle or shake roof; low and rambling; generally attached garage; and indoor/outdoor living.



Building Quality

One of the most important reasons for inspecting a property is to determine its quality of construction and condition. The appraiser must be knowledgeable as to structural details of buildings. All exposed portions of a building should be closely inspected to ascertain the materials used, the present condition, and the type and quality of construction, which may be classified as follows:

A. Low quality.

1. Competitive low cost house which does not exceed the minimum building codes.

B. Fair quality.

1. Plain and inexpensive finishes on both interior and exterior.
2. Cheap quality finish hardware, lighting fixtures, and heating.
3. Generally erected in areas of low purchasing power.
4. Typically, stucco exterior, concrete slab floor, composition roof.

C. Average quality.

1. Meets VA and FHA standards.
2. Usually purchased by persons of moderate income.
3. Medium standard of construction with some low cost refinements.
4. Usually of stucco exterior, hardwood flooring, composition roof or shingle.
5. Finish hardware, lighting fixtures and heating of average quality.
6. House found in large tract developments.

D. Good quality.

1. Good architectural design, workmanship and materials.
2. Stucco walls with wood and masonry trim, hardwood floors, shingle roofs.
3. Usually contains two bathrooms, forced air furnace or equal heating, good quality lighting fixtures and finish hardware.
4. Usually has extra built-in equipment in kitchen.

E. Very good quality.

1. Generally, custom designed by architect.
2. Home contains many extra features.
3. Stucco walls with extensive wood or masonry trim, hardwood flooring, tile or concrete roofs.
4. Two or more bathrooms, forced air heating, good quality finish hardware and lighting fixtures.
5. Custom fireplaces.

F. Excellent quality.

1. Custom designed by architect.
2. Extra features are of the highest quality and design.
3. Stucco walls with redwoods or cedars or other fine woods, stone trim, hardwood, marble and custom carpet floorings, clay tile, slate roofs, copper gutters and so on.
4. A bath with each bedroom, walk-in closets, zoned heating, special wood finishes such as teak, cherry, walnut, etc., designer lighting including recessed art lighting.
5. Custom fireplaces, custom wood libraries, bars, butler's pantries, granite or marble counters in baths and kitchen, gourmet appliances.

Functional Utility

Good architecture is concerned with room layout and functional utility as well as exterior style. A functional analysis of a property measures the conveniences and economy in the use of the property. The combined factors of usefulness and desirability have an effect on a property's marketability. The degree of its functional utility is important in any consideration of its marketability. Thus, marketability is the ultimate test of functional utility.

Functional Utility Checklist**A. Building.**

1. Living room.
 - a. Adequacy of floor and wall space for proper placement of furniture.
 - b. Circulation - should not have to pass through long living room to reach other parts of the house.
 - c. Fireplace should be away from the traffic flow.
 - d. Wall spaces - adequate for furniture arrangements.
2. Dining room or area.
 - a. Ease of access to kitchen.
 - b. Size of room or area governed by overall size of house.
 - c. Best if room is nearly square.

3. Bedrooms.
 - a. Master bedroom should be of adequate size (minimum 10' x 12').
 - b. Other bedrooms (minimum 9' x 10') .
 - c. Cross ventilation should be provided.
 - d. Located away from family areas and kitchen for privacy.
 - e. Should not have to go through one bedroom to enter another.
 - f. Closet space should be adequate (minimum depth 2 feet; minimum area 6 square feet).
 - g. Proximate to full bath facilities.
4. Kitchen.
 - a. Workspace should be ample and efficient in plan.
 - b. Equipment should be centrally located to eliminate unnecessary foot travel.
 - c. Walls, ceilings and floors should be of easily maintained materials.
 - d. Adequate provision should be made for proper lighting and ventilation.
 - e. Kitchen should be conveniently located in relation to dining areas and family room.
 - f. Kitchen should have an exterior entrance.
 - g. Laundry facilities should be adjacent to kitchen.
5. Bathrooms.
 - a. Proper location with respect to other rooms.
 - b. If only one bathroom exists, it should be located off the central hall.
 - c. Bathroom should not open directly into kitchen or living room.
 - d. Adequate ventilation - exterior window or automatic exhaust fan is necessary.
 - e. Floors, walls, and ceilings easily cleaned and maintained.
6. Closets and storage.
 - a. At least one clothes closet per bedroom.
 - b. Adequate linen closet space.
 - c. Storage closets should be centrally located.
 - d. A storage area should be provided near the laundry equipment.
 - e. Exterior storage necessary if there is only a carport.

B. Site.

1. Construction should be related to the size of the building site.
2. The house should be so located on the land that it relates to the building site or "belongs."
3. Adequate front, rear and side yards are necessary for light and privacy. Yards may be clustered in planned unit developments.
4. A private service yard for drying clothes and storage of refuse should be convenient to the kitchen.
5. Entrance to the garage should be convenient and readily accessible.
6. Proper landscaping.
7. Recreational and garden facilities.
8. Adequate yard improvements.

Broker's Guidelines for Considering Physical Characteristics of Real Property for FHA Insurance Purposes

- A. **Visual appeal of property.** How well will the property as a whole retain its market appeal?
1. Exterior design of structures.
 - a. Visual appeal based upon the probability of continuing market acceptance.
 - b. Certain architectural styles are short-lived in their acceptance and become obsolete.
 2. Setting.
 - a. Measures the property's appeal in the market because of terrain, accessory buildings, walks, landscaping.
 - b. The dwelling and surroundings should present a pleasing and unified composition.
 3. Interior design of dwelling.
 - a. The interior design should exhibit simplicity of treatment, harmony in proportions and refinement in design.
 - b. Interior permanent features should be up-to-date and of adequate construction.
- B. **Livability of property.** The degree of usefulness, convenience and comfort which the property affords is determined by:
1. Site utilization.
 - a. Considers all aspects of the site and its arrangements as these affect the livability of the entire property.
 - b. The lot characteristics including size, shape, topography, orientation and natural advantages are considered.
 2. Dwelling space utilization. Consideration is given to the size and efficient distribution of space within the structure.
 3. Room characteristics. Consideration is given to the size and proportion of the rooms in relationship to the overall area of the dwelling. The following factors are considered:
 - a. Room orientation.
 - b. Circulation.
 - c. Privacy.
 - d. Closet and storage space.
 - e. Kitchen efficiency.
 - f. Service facilities.
 - g. Insulation.
- C. **Natural light and ventilation.** The effect of natural light and natural ventilation on the desirability, livability and healthfulness is considered.
1. The proper amount or ratio of natural light to room area should be maintained.
 2. Ventilation of all rooms is studied to measure its effect on desirability of the dwelling.
 3. Cross ventilation desirable in all bedrooms.
- D. **Structural quality.** The quality of structural design, materials, and workmanship is determined for the dwelling. The component elements to be considered are as follows:
1. Foundations.
 2. Wall construction.
 3. Partitions.
 4. Floor construction.
 5. Ceiling construction.
 6. Roof construction.

- E. **Resistance to elements and usage.** A determination is made as to the resistance of the dwelling to the effects of weather, decay, corrosion, fire, and deterioration. Consideration is given to three categories:
1. Lot improvements.
 - a. How is the soil protected from erosion?
 - b. Is the land properly graded so that the structure is not damaged by water?
 - c. The yard improvements such as walks and walls should be of adequate materials.
 2. The building exterior. Analysis is made with reference to the resistance of the exterior of the building to the effects of the elements.
 3. Building interior. Consideration is given to the resistance of interior surfaces and materials to determine wear and tear and deterioration.
- F. **Suitability of mechanical equipment.** Measures the extent that the equipment contributes to the desirability and appeal of the dwelling through convenience, economy, and comfort. Consideration is given to:
1. Plumbing system.
 2. Heating system.
 3. Electric system.
 4. Supplementary equipment.

THE APPRAISAL PROCESS AND METHODS

USPAP Standards 1 and 2 guide the appraiser through the appraisal process. Standard 1 covers all of the development activities that are distinctly different from the final step, reporting, which is covered in Standard 2.

The following summarizes the appraisal process required in Standard 1:

- A. Define the appraisal problem
 1. Identify the client and intended users
 2. Identify the intended use
 3. Identify the type and definition of value
 4. Determine effective date of the opinion
 5. Identify the relevant characteristics of the subject property
 6. Identify assignment conditions (Extraordinary assumptions and hypothetical conditions)
- B. Determine the scope of work necessary to solve the appraisal problem
- C. Perform data collection and analysis
 1. Market analysis (demand studies, supply studies, marketability studies)
 2. Highest and best use analysis (site as though vacant, ideal improvement, property as improved)
- D. Application of the approaches to value
 1. Cost
 2. Sales Comparison
 3. Income
- E. Reconciliation of value indications and final opinion of value

Standard 2 sets forth the actual reporting of the value opinion. USPAP defines the report as: “Any communication, written or oral, of an appraisal, appraisal review, or appraisal consulting service that is transmitted to the client upon completion of the assignment.” Standard 2 covers the final step in the appraisal process and addresses both the reporting and communication.

METHODS OF APPRAISING PROPERTIES

There are three approaches to consider in making a market value estimate. These approaches are:

Sales comparison approach. Recent sales and listings of similar type properties in the area are analyzed to form an opinion of value.

Cost approach. This approach considers the value of the land, assumed vacant, added to the depreciated cost new of the improvements. This is considered a substitute or alternative to producing a similar improved property.

Income approach. The estimated potential income of real property is capitalized into value by this approach.

Not only does each parcel of real estate differ in some respects from all other properties, but there are many different purposes for which an appraisal may be made. Each variation of purpose could result in a considerable, yet logical, variation of estimated value. For example the nature of the property, whether noninvestment, investment or service; the purpose of the purchase, whether for use, investment or speculation; and the purpose of the appraisal, such as for sale, loan, taxation, insurance and the like, all constitute matters which will influence the proper methods of appraisal approach and the final result reached by the appraisal.

Consequently, the first step in any appraisal procedure is to have a clear understanding of the purposes for making the appraisal and the value to be sought. The adequacy and reliability of available data also are determining factors in the selection of the approaches to be employed. A lack of certain pertinent or up-to-date information may well eliminate an otherwise possible approach.

Each approach is used independently to reach an estimated value. Then, as a final step, conclusions are reached as to one appropriate value opinion. This procedure is known as reconciliation.

THE SALES COMPARISON APPROACH

This approach, formerly known as the market data comparison approach, is most generally adaptable for use by real estate brokers and salespersons. It lends itself well to the appraisal of land, residences and other types of improvements which exhibit a high degree of similarity, and for which a ready market exists. The principle of substitution is the basis of this approach. The buyer should not pay more for a property than the cost of acquiring a comparable substitute property. An analysis of market data is necessary in all three approaches to value.

The mechanics of the sales comparison approach involve the use of sales and market data of all kinds in order to compare closely the property being appraised with other similar properties which have recently been sold or are offered for sale as to time of the sales, location of the sales and physical characteristics of the improvements. The sources used for determining value include actual sales prices, listings, offers, rents and leases, as well as an analysis of economic factors affecting marketability.

Sources of Data

Sales or market data are obtained from many sources including:

Appraiser's own files. Information gathered on previous assignments might provide information for the present appraisal.

Public records. The county assessor's office keeps a record of all sales transactions recorded within the county. The date of recording of any deed may be obtained from the recorder's office. The exact legal description as well as legal seller and buyer can be obtained from an inspection of the deed (or facsimile). The documentary transfer tax applies on all transfers of real property located in the county. Notice of payment is entered on the face of the deed or on a separate paper filed with the deed. Tax is computed at the rate of 55 cents for each \$500 of consideration or fraction thereof. If a portion of the total price paid for the property is exempt because a lien or encumbrance remains on the property, this fact must be stated on the deed or on a separate paper filed with the deed.

Multiple listing offices, fellow appraisers or brokers. Information on listings, offerings, and sales may frequently be obtained from real estate multiple listing facilities, real estate offices or by appraisers familiar with the area.

Legal property owner, sellers or buyers. When viewing comparable sales and other pertinent data in an area, additional information is solicited by interviewing property owners living in the neighborhood. The appraiser should try to confirm the sales price and circumstances of the sale with buyer, seller and/or broker. If informed of the appraiser's purpose, parties will usually verify and explain the sale.

Classified ads and listings. Ads are a source of information on properties currently being offered for sale. If possible, the appraiser's name should be on the mailing list of banks, savings and loan, and other institutions selling properties.

Listing prices may often indicate the probable top market value of a specific property while bid prices may normally indicate the lowest probable value. Both are subject to variation based on motivation, but a reasonable number of properties falling into this category will provide a bracket within which a current fair value may be found. Offers are likely to approach market value more closely than are listings. However, an offer to purchase is not usually a matter of common knowledge.

The Procedure

The procedure used in the sales comparison approach method is to systematically assemble data concerning comparable properties. Appraisers consider the principle of substitution, seeking comparables that are as similar to the subject as possible in regard to: neighborhood; location; site; improvement size; bedrooms and baths; age; architectural style; financing terms and general price range. The greater the number of good comparable data used, the better the result, provided a proper analysis is made. The approach is based on the assumption that property is worth what it will sell for in the absence of undue stress, and if reasonable time is given to find a buyer. For this reason, the appraiser should look behind sales and transfers to ascertain what influences may have affected sales prices, particularly if only a few comparisons are available.

Proper comparisons between like properties are ideally based on an actual inspection. Inspections should determine: the condition of improvements at time of sale, not as of date of inspection; room arrangement and room count so that the utility of the data may be compared to the subject property; yard improvements and their influence upon the sales price; the sales price (from buyer, seller or broker), to determine if the sale was an arm's length or open market transaction; size and topography of the lot. For nearly comparable properties, negative (downward) adjustments should be made to the comparable for the subject's poor repair, poor design, existing nuisances, etc. Conversely, positive adjustments should be made to the comparables for the subject's superior design, view, special features, better condition, higher quality of materials, landscaping, and the like.

Unless the sales being compared are of recent date, consideration must also be given to adjusting values in keeping with the economic trend of the district and the worth of the dollar. Financing terms receive value adjustment considerations, e.g., for favorable existing assumable financing, or perhaps seller-assisted financing.

Units and elements of comparison. The common units of comparison used by appraisers in the sales comparison approach are property components that can readily be used for comparison purposes: site size; square footage; number of rooms; and number of units. Elements of comparison are characteristics in either the property or the transaction itself that cause prices to vary. These principal elements of comparison are financing terms, time (the market conditions at the time of the sale), sale conditions (no pressures/arm's length), location, physical characteristics, and income (if any) from the property.

Using the appropriate units and elements of comparison for the subject and each comparable, the appraiser assigns an estimated adjusted amount (dollar or percentage) for each difference found in the items of comparison (number of bathrooms, view, square footage, financing, forced sale). An adjusted price is thus established for each comparable property that should realistically reflect what the subject would sell for in the current market. The less comparable properties are then eliminated from consideration and greatest weight is given to the comparable sales most similar to the property being appraised. Through this judgment or reconciliation process, the appraiser arrives at the final opinion of value for the subject property.

Advantages. Some advantages of using the sales comparison approach are:

1. It is the most easily understood method of valuation and in most common practice among real estate brokers and salespersons.
2. Many times it is the most efficient method of determining the market value of a property due to the availability of transactions involving willing buyers and sellers.

3. It is particularly applicable for appraisal purposes involving the sale of single family residences and loan arrangements therewith. These make up the great bulk of real estate transactions.

Disadvantages. Some disadvantages of the comparison approach method are:

1. Locating enough “nearly alike” properties which have recently sold or been listed.
2. Adjusting amenities to make them comparable to the subject property. The greater the amount of adjustment or number of adjustments, the less reliable the comparable becomes.
3. Dated sales become less reliable in a changing market.
4. Occasional difficulty confirming transaction details.
5. Limitations in rapidly changing economic conditions and periods of high inflation and interest rates, when property appreciation rates may cause value opinions that are lower than the sale prices. (This is because appraisers are required to rely heavily on confirmed closed sales).

Application of the Procedure - Residential Sales

Like properties are always compared. The more current the data the better. The suggested order for making unit and element comparisons is in this sequence:

1. finance terms
2. time (market conditions)
3. sale conditions
4. location
5. physical characteristics
6. other (e.g., special considerations for income property)

The steps.

1. Research the market for *bona fide* “like-kind” recent market data. Select data. Verify.
2. Select the appropriate units and elements of comparison. Adjust the sales price of each comparable (or eliminate it from consideration). The adjustment is always made to the comparable, not to the subject property.
3. Each comparable will have its own value indication. Eliminate the less comparable properties. Set out comparison results in chart or grid form. Using judgment and experience, reconcile or correlate the adjusted sales prices of the comparables and, by giving greatest weight to the sale that is most compatible to the subject property, assign a value opinion to the subject. Do not average the adjusted sales prices of the comparables. Reconciliation is a judgment process. It is not mechanical.

Example. Assume that the house to be appraised is a 2,400 square foot, 5-year old, single-family tract home located two blocks from the beach, with a fair view, stucco, 10 rooms, 4 bedrooms, 3 baths, 3 car garage. It is in good condition.

Prices have been increasing at 1% a month. The appraiser has selected from the neighborhood comparables which are equal in most of their financing and physical characteristics, except as shown on the rating chart. The value or sales price for the subject property is determined as shown on the chart below.

SALES COMPARISON DATA APPRAISAL RATING GRID –

SINGLE-FAMILY RESIDENCE TRACT HOME

Elements/Units	Comparables			Subject
	Data 1	Data 2	Data 3	
Sales Price	\$164,000	\$176,000	\$178,000	?
Adjustments				
Financing Terms	Normal	Normal	Normal	Normal
Conditions of Sale...	Normal	Normal	Normal	Normal
Time (Sale Date).....	June, 2009	Nov., 2009	April, 2010	Aug., 2010
Adjustment 1%/mo	+\$22,960	+\$15,840	+\$7,120	
Distance to Beach ...	1 Block	3 Blocks	4 Blocks	2 Blocks
Adjustment	*(superior) -\$6,000	*(inferior) +\$2,000	*(inferior) +\$4,000	
Garage.....	Equal	Equal	Equal	Equal
Age	Equal	Equal	Equal	Equal
Rooms.....	Equal	Equal	Equal	Equal
Bathrooms.....	Equal	Equal	Equal	Equal
View	None	Some	Fine	Fair
Adjustment.....	*(inferior) +\$4,000	*(inferior) +\$1,000	*(superior) -\$6,000	
Square footage	2,400	2,430	2,390	2,400
Adjustment.....	<u>0</u>	<u>0</u>	<u>0</u>	
Net Adjustments ...	\$20,960	\$18,840	\$5,120	
Adjusted Sale Price.	\$184,960	\$194,840	\$183,120	
Indicated Value				\$185,000

* Inferior means the comparable is inferior to the subject property in this regard. Superior means the opposite. Subtract the adjustment if the comparable is superior to the subject property. Add the adjustment if the comparable is inferior to the subject property.

Reconciliation: Data 2 is close to the subject property in size, location, and view although not as good as the subject. Data 3 is the latest sale, but has the greatest difference in view and location. Data 1 is the oldest sale but is most useful for confirming the indication of value. Indicated value: \$185,000.

COST APPROACH

The Cost Approach views value as the combination of:

the value of the land as if vacant; and

the cost to reconstruct the appraised building as new on the date of value, less the accrued depreciation the building suffers in comparison with a new building.

The principle of substitution applies: i.e., value tends to be set by the price of an equivalent substitute.

The total cost of the land as if vacant, plus the reconstruction cost new of the building with all direct and indirect expenses and profit, and before deduction of depreciation, will tend to set the upper limit of value. In this view, the cost new can be used as a benchmark for measuring the other approaches.

The Procedure in Brief

1. Estimate the value of the land as though vacant and available for development to its highest and best use.
2. Estimate the replacement or reproduction cost of the existing improvements as of the appraisal date.
3. Estimate the amount of accrued depreciation to the improvements from all causes (physical deterioration, functional obsolescence, or external obsolescence).
4. Deduct the amount of the accrued depreciation from the replacement cost new to find the estimate of the depreciated value of the improvements.
5. Add the estimated present depreciated value for the improvements to the value of the land. The result is an indication of the value for the subject property.

Cost New Bases

The Cost Approach views the value of the building at its cost of reconstruction as new on date of value. There are three bases of reconstruction cost as new:

1. Historic Cost indexed to Cost New;
2. Reproduction Cost New; and
3. Replacement Cost New. Each basis has value to a cost-as-new study, but terms should not be confused.

Historic cost indexed to cost new. Historic Cost is the actual cost of the building when originally constructed, yesterday or fifty years ago. By use of price indices from building or engineering cost services, or from the original building contractor, Historic Cost can be “indexed” to Cost New on date of value. Indexed Historic Cost can be very useful if the building is fairly new and/or it is so unique that it is the only reliable value base. The advantage of Indexed Historic Cost is the accuracy of employing actual building costs. The disadvantage is that the older the costs are the less reliably they can be indexed. When considering Indexed Historic Costs, the appraiser should be certain that historic costs were normal costs at time of construction and that historic costs, as indexed, will accurately reflect Cost New on date of value in the then current dollars.

Reproduction cost new is the cost, on date of value, of constructing a replica of the appraised building. This is a replica in actual design and materials. In this method, the cost-as-new estimate is made as if looking at plans of an exact duplicate of the present building. The advantage of Reproduction Cost New is the greater accuracy of duplicating the building in actual design and materials. The disadvantage is that advances in building construction and methods, materials and design make cost estimates of obsolete building construction very difficult and wildly distorted for materials no longer reasonably available or requiring large amounts of hand labor. Reproduction Cost New is most useful for study of refined methods of depreciation, unique construction, and occasional legal requirements for court testimony.

Replacement cost new views the building as if reconstructed with modern methods, design and materials that would most closely replace the use of the appraised building but provide the same utility. For example, an older brick warehouse would be constructed today with concrete block or tilt-up cast slab construction. The advantage of Replacement Cost New is the ready availability of accurate current costs, and a better understanding by all parties of modern methods, design and materials. The disadvantage is the subjective decisions of proper current replacement materials and design for older construction. In actual practice, the Replacement Cost New is the most frequently used Cost Approach base.

Steps in the Cost Approach

- A. An estimate is made as to the land’s current market value, assumed vacant and available for improvement to its highest and best use. Land value is usually based on a market approach utilizing comparable market data of similar sites in the area.
- B. An estimate is made of the cost new of reconstructing the buildings and other improvements.
 1. The appraiser selects the proper cost new base:

- a. *Historic Cost* of appraised building indexed to cost new on date of value.
 - b. *Reproduction Cost* of duplicating the replica of the appraised building using original materials and design on date of value.
 - c. *Replacement Cost* of replacing the use and utility of the appraised building using modern materials, methods, and design on date of value.
2. The appraiser completes property inspection, description, measurement, inventory, and plot plan of appraised building improvements and equipment, with notes regarding type, style, quality, and condition of building materials, workmanship and condition.
 3. The appraiser selects appropriate method of cost new estimating.
 - a. The ***Square-Foot Method*** is the most common method used by appraisers on the West Coast to estimate the cost of construction. The property being appraised is compared with similar structures where costs are known, and which have been reduced to units per square foot of floor area. Standard type buildings whose costs are known are broken down to a cost per square foot of floor area. The building being appraised is compared with the most comparable standard building and its cost per square foot is used for the subject property. Adjustments must be made for size of building, and various exterior and interior features. Though adjustments cannot be made for many variables, this method, in most instances, is accurate enough for the real estate appraiser. The square-foot method can be used and applied faster than any other estimate.
 - b. The ***Cubic-Foot Method*** is similar to the square-foot method, except the cubic contents of buildings are compared instead of the square footage of the floor area. This method is most popular in the Eastern United States. If used properly, it is more accurate than the square foot method, since the height as well as area of the building is taken into consideration. This method is most often used for industrial or warehouse buildings.
 - c. The ***Quantity Survey Method*** involves a detailed estimate of all labor and materials for each component of the building. Items such as overhead, insurance, and contractor's profit must be added to direct costs. This is a very accurate but time-consuming method to arrive at costs. Because of the detail and time required, this method is seldom used, except by building contractors and professional cost estimators.
 - d. The ***Unit-in-Place Cost Method*** entails calculation of the cost of units of the building as installed. The total costs of walls in place, heating units, roof, etc. are obtained on a square foot basis, including labor, overhead, and profit. This is a detailed, accurate method generally used for checking on new construction units. It is seldom used by appraisers because specialized knowledge is necessary to gather all elements of unit costs.
 4. The appraiser investigates cost sources and estimates cost-as-new of all buildings and improvements. Costs must be measured accurately. They are classified as direct (hard) costs and indirect (soft) costs. Indirect costs are usually associated with the administration of the project while direct costs are expenditures for labor, equipment and materials, overhead and profit.
 - a. Cost sources:
 - (1) Costs of comparable buildings under construction.
 - (2) Owners, builders, and/or contractors of comparable buildings.
 - (3) The contractor of original building, if available.
 - (4) Published cost services (handbooks or computerized services providing current comprehensive cost data, by local areas and general construction types).
 - (5) Professional cost estimators.
 - b. The appraiser completes the cost estimate to include all:
 - (1) Direct expenses of construction such as labor, materials and equipment and engineering for the building, site preparation, street and utility work, landscaping, etc.

- (2) Indirect expenses such as legal, title, appraisal and feasibility study fees, licenses, permits, *ad valorem* taxes during construction, demolition and removal costs, inspections, insurance during construction, financing charges, accounting, etc.
 - (3) Developers' overhead, supervision, and profit; for planning, construction, and sale of the project to "turnkey" condition (that is, completely ready for a new purchaser/occupant) and selling costs.
- C. The appraiser estimates the accrued depreciation and deducts from cost-as-new estimate. This amount must be deducted from the cost-as-new to determine the present value of the improvements. The difficulties of correctly estimating depreciation tend to increase with the age of the improvement. Experience and good judgment are among the necessary qualifications for making a realistic estimate of proper depreciation. There is no justification in assuming that improvements necessarily depreciate at a rate corresponding to their age.
- D. The appraiser adds the land value to depreciated value of improvements for indicated value by Cost Approach.

DEPRECIATION

In connection with the appraisal of real property, depreciation is defined as "loss in value from any cause." It is customarily measured by estimating the difference between the current replacement or reproduction cost new and the estimated value of the property as of the date the property was appraised.

Contrasting with depreciation is *appreciation* of value from inflation or special supply and demand forces relating to the specific property. Appreciation may reduce or offset entirely a normally anticipated decrease of value due to depreciation.

Depreciation includes all of the influences that reduce the value of a property below its cost new. The principal influences are often grouped under three general headings and subdivided as follows:

1. Physical deterioration resulting from:
 - a. Wear and tear from use;
 - b. Negligent care (sometimes termed "deferred maintenance");
 - c. Damage by dry rot, termites, etc.; or
 - d. Severe changes in temperature.
2. Functional obsolescence resulting from:
 - a. Poor architectural design and style;
 - b. Lack of modern facilities;
 - c. Out-of-date equipment;
 - d. Changes in styles of construction;
 - e. Construction methods and materials obsolete by current standards;
 - f. Changes in utility demand such as desire for master bath or more garage space; or
 - g. Superadequacies in improvements, such as pools or excessive room additions, where the actual cost is more than the market is willing to pay for those improvements.
3. External obsolescence resulting from adverse environmental and economic influences outside the property itself, such as:
 - a. Misplacement of improvement (not typical for neighborhood);
 - b. Zoning and/or legislative restrictions;
 - c. Detrimental influence of supply and demand;
 - d. Change of locational demand; or
 - e. Proximity to undesirable influences such as highly trafficked streets, freeways, airport flight patterns, toxic waste sites, or high tension power lines.

The first two categories of accrued depreciation are considered to be inherent within the property and may be curable or incurable. The third category is caused by factors external to the property and is almost always incurable.

Appraisal and Income Tax Views - "Book" vs. Actual Depreciation

It is important to understand that "depreciation" is a word with two meanings: one for the appraiser and another for the owner concerned with tax position.

Book depreciation. Depreciation, for the owner's income tax position, is "book" depreciation, a mathematical calculation of steady depreciation from owner's original purchase price or cost basis. This "book" depreciation allows the owner to recover the cost of the investment over the "useful life" of the improvement. It accrues annually and is an income tax deduction. In this sense, the owner's accountant sees depreciation as a deduction from gross income.

Frequently, "book" depreciation results in negative gross income, at least on paper. The building seems to be losing value faster than the income replaces it. This gives the owner a "paper loss" that can be offset against other income. This "paper loss" or "tax shelter" is a motivating factor for purchase or exchange of many income properties.

"Book" depreciation is:

1. an allowable deduction from cost for accounting or income tax purposes;
2. determined by owner's policy and to meet IRS requirements; and
3. deducted from owner's original (historic) cost.

"Book value" is the current value for accounting purposes of an asset expressed as original cost plus capital additions minus accumulated depreciation, based on the method used for the computation of depreciation over the useful life of the asset for income tax purposes. Depreciation is allowed on improvements only, not land.

The book value of the property may be ascertained at any given time by adding the depreciated value of the improvement to the allocated value of the land.

Actual depreciation. The "book" depreciation from owner's original cost is not the depreciation normally considered by the appraiser. The appraiser looks not to owner's original cost, but cost new on date of value. From this current cost new, the appraiser deducts the estimate of accrued *actual* (not book) depreciation. Depreciation (loss in value) is estimated only for improvements.

Actual depreciation used by appraisers is:

1. loss in value;
2. determined by market data, observed condition, etc.; and
3. deducted from current reconstruction cost new.

Because accountants and appraisers select rates of depreciation for different purposes, accruals for book and actual depreciation vary considerably. While both estimators may use the same period as to the remaining economic life of the property and may also use the same method, additional considerations may affect the resultant rate. Whereas the accountant may be restricted because of accounting conventions, the appraiser is under no such restrictions.

The real estate agent who is determining values should understand the necessity for following proper appraisal procedures and should not rely on book values either to estimate accrued depreciation or for future depreciation accruals.

Methods of Calculating Accrued Depreciation

Accrued depreciation is depreciation which has already occurred up to the date of value. Remainder depreciation is depreciation which will occur in the future. Accrued depreciation may be classified either as curable or incurable. The measure between curable and incurable is economic feasibility. It is possible to physically restore or cure most depreciation such as by expensive restoration of old homes. However, in most circumstances, cure of deficiencies is measured by the economic gain (increased rents) compared with the cost of the cure. Three methods of estimating accrued depreciation are discussed next.

Straight line or age-life method is depreciation which occurs annually, proportional to the improvement's total estimated life.

For example, an improvement with an estimated total life of 50 years would be said to depreciate at an equal rate of 2 percent per year. (2 percent x 50 years equals 100 percent depreciation.)

The effective age of the building is generally used instead of the actual age. Effective age is the age of a similar and typical improvement of equal usefulness, condition and future life expectancy. For example, if a building is actually 25 years of age but is as well maintained and would sell for as much as adjoining 20-year-old properties, it would be said to have an effective age of 20 years.

The straight line method is: easy to calculate; used by the Internal Revenue Service; and easily understood by the lay person.

However, in actuality, buildings do not depreciate in a straight line at a stated percentage each year, but will vary according to maintenance and demand for the type of structure.

The **cost-to-cure** or observed condition method (breakdown method) involves:

1. Observing deficiencies within and without the structure and calculating their costs to cure. The cost to cure is the amount of accrued depreciation which has taken place.
2. Computing an amount for physical deterioration or deferred maintenance for needed repairs and replacements.
3. Determining and assigning a dollar value to functional obsolescence due to outmoded plumbing fixtures, lighting fixtures, kitchen equipment, etc.
4. Measuring functional obsolescence which cannot economically be cured (e.g., poor room arrangements and outdated construction materials) and calculating the loss in rental value due to this condition.
5. Calculating external obsolescence (i.e., caused by conditions outside the property) and determining the loss of rental value of the property as compared with a similar property in an economically stable neighborhood. The capitalized rental loss is distributed between the land and the building.

This is the most refined method of examining complex causes and cures of depreciation. However, it can be difficult to calculate minor or obscure depreciation accurately. Also, measurement by rental loss is sometimes difficult to substantiate.

A **combination** of the straight line and cost-to-cure methods may be used to:

- determine the normal depreciation as if the property is not suffering from undue depreciation; and,
- add any excess deterioration and obsolescence.

Reproduction or replacement cost method. The subject property is improved with a duplex, two detached garages, a covered porch for each unit and common driveway and walk.

Measurements and current cost replacement figures for the improvements are as follows:

Each unit of duplex is 25' x 35' @ \$55.00 per sq. ft.

Each detached garage is 21' x 25' @ \$20.00 per sq. ft.

Each covered porch is 6' x 10' @ \$14.00 per sq. ft.

Driveway is 20' x 100' @ \$2.40 per sq. ft.

Walk is 3' x 40' @ \$2.40 per sq. ft.

The improvements are now 12 years old and it is determined that such improvements have a remaining economic life of 38 years. The current lot value, by comparison, is \$45,000.00. Depreciation computations are based on the use of the straight line method.

What is the replacement cost new and the present value of this property?

Each duplex unit (25' x 35' x \$55.00) x 2	\$96,250.00
Each detached garage (21' x 25' x \$20.00) x 2	21,000.00
Each covered porch (6' x 10' x \$14.00) x 2	1,680.00
Driveway (20' x 100' x \$2.40)	4,800.00
Walk 3' x 40' x \$2.40	<u>288.00</u>
Improvements – Total Replacement Cost New.	124,018.00

Depreciation:

12 yrs. + 38 yrs. = 50 yrs. life of improvements when new

100 ÷ 50 = 2 percent annual depreciation rate, or recapture rate.

12 yrs. x 2 percent = 24 percent total depreciation to date.

124,018 x 24 percent = Total depreciation in value to date..... 29,764.00

Total value of improvements less depreciation

	\$94,254.00
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Plus site value. 45,000.00

Total Current Value by Replacement Cost Approach \$139,254.00

Market data method (more commonly known to appraisers as “abstraction.”) A comparative method is sometimes used in residential appraisals where the property being appraised can be compared with market data of buildings of similar type and condition.

1. From the sales price of a comparable residential property, deduct an estimate of land value.
2. From the resulting total comparable improvement value, deduct the estimated contributory value of secondary improvements and landscaping.
3. The result is the value of the comparable main residence at its total depreciated value in place.
4. Divide this main residence value by the residence square footage. This yields depreciated unit value.
5. By multiplying the appraised building square footage by the unit value of the comparable residence, the total indicated depreciated value is found for the appraised residence.

Sales price of comparable property	\$180,000
Less estimated land value	<u>- 55,000</u>
Improvement Value	125,000
Less estimated value of secondary improvements and landscaping	<u>- 23,000</u>
Value of comparable residence	102,000
Divide by area of comparable residence	<u>÷ 2,900 sq.ft.</u>
Depreciated unit value of comparable residence	\$35.17/sq.ft.
Multiply by size of appraised residence	<u>x 2,850 sq.ft.</u>
Indicated depreciated value in place of appraised residence	\$100,234

Advantage of the Market Data Method: This method can be an accurate measure of depreciation from the market.

Disadvantage of the method: It is difficult to obtain truly comparable market data and difficult to accurately estimate land value and secondary improvement value for deductions for main residence value indication.

Age-life method using effective age. A house has an actual physical age of 25 years with an overall useful life of 50 years, thus depreciating at the rate of 2 percent a year. It is the opinion of the appraiser that the subject

house is of the same condition and utility as similar houses that are only 20 years of age. Therefore, the house has been assigned an effective age of 20 years.

The accrued depreciation would thus be 20 years times 2 percent or 40 percent.

Calculated cost new	\$120,000
Accrued depreciation (40 percent x \$120,000)	<u>48,000</u>
Depreciated value of improvement.	72,000
Plus land value	<u>50,000</u>
Indicated value by cost approach.....	\$122,000

Measuring physical deterioration. A store building has a remaining useful life of 30 years and an effective age of 20 years. Present reproduction cost for the structure is \$230,000. The roof is 75% deteriorated. A new roof will cost \$10,000. The air conditioning and heating systems are 40% depreciated. Their installed cost new is \$8,000. What is the total amount of physical deterioration?

The building, under the straight-line or age-life method, is 40% depreciated ($100\% \div 50 = 2\% \times 20$ years effective age = 40%). This 40% depreciation to the building is to be applied to the amount of the building's reproduction cost less the depreciation already taken on the other components.

Depreciation to roof (.75 x \$10,000)	\$7,500
Depreciation to air conditioning and heater (.40 x \$8,000).....	\$3,200
Depreciation to rest of building (.40 x \$212,000)	<u>\$84,800</u>
Total physical deterioration	\$95,500

Income approach - future depreciation. Future depreciation is loss in value which has not yet occurred but will come in the future and is of significance in the capitalization of income method, which will be discussed next. In the income approach to valuation, depreciation is based on the remaining economic or useful life, during which time provision is made for the recapture of the value of improvements. It is the return "of" the investment, as differentiated from the return (interest and profits) "on" the invested capital. Under the income approach, this depreciation is usually measured by one of two methods: straight-line or sinking fund.

In straight-line depreciation, a definite sum is deducted from the income each year during the total estimated economic life of a building to replace the capital investment. If the appraiser estimates that a building will have a remaining life of 25 years, this method provides that 1/25 or 4 percent of the building's value be returned annually as a deduction from net income.

The sinking fund method also includes a fixed annual depreciation deduction from income, but with yearly reserves from such funds deposited into a sinking fund which, with possible compound interest, may offset the depreciated value of the structure and be collectible at the end of the building's useful life. Accruals for future depreciation to replace the capital investment are in addition to and essentially different from both maintenance charges and reserves for periodic replacement of curable depreciation.

Should there be any estimated salvage value to the improvement at the end of its economic life, this amount need not be returned through the annual depreciation charge under either the straight-line or the sinking-fund method.

INCOME (CAPITALIZATION) APPROACH

The Income Approach is concerned with the present worth of future benefits (the income stream) which may be derived from a property. This method is important in the valuation of income-producing property. An important consideration in this approach is the *net* income which a fully informed person using competent management can expect to receive. An alternative, using *gross* income and gross income multipliers is explained later in this chapter.

The process of calculating the present worth of a property on the basis of its capacity to produce an income stream is called *capitalization*. The Income Approach is based primarily on the appraisal principle of anticipation.

Appraiser's and Owner's Viewpoints

A real estate professional will understand that there are several differences in the owner's and appraiser's viewpoints on income property.

An owner purchases income property as an investment, based on personal desires and tax position. The owner frequently views the investment as equity in a financed property. "Equity" is the owner's down payment or the difference between the loan amount and the value or price of the property. The owner calculates the payments on the loan as an expense of owning the property, and deducts from income tax the interest paid on the loan and the "book" depreciation from the purchase price or cost basis. The owner can deduct only actual expenses, not reserves for future expenses, and can compute gross income only from income actually collected (or owed), not just projected. The owner looks for a profitable resale or exchange at a higher price or favorable tax position.

The appraiser reconstructs expense and income into amounts the well-informed investor would anticipate, without specific regard for personal equity, spendable income, or tax consequences. Using methods outlined below, an appraiser analyzes an income property to ascertain its value to the market *generally*, i.e., the Market Value.

Capitalization

Capitalization converts the future income stream into an indication of present worth of property. The two income capitalization methods used in appraisal are Direct capitalization and Yield capitalization. In Direct capitalization, such as Overall Rate and GRM analysis, the income from a single annual period is converted to an opinion of value. Yield capitalization measures the present worth of a series of income payments occurring over the multi-year life of the investment.

Income property investors expect a return of the capital invested, plus a return on that capital. The return of capital (recapture) may occur through income payments received, the net proceeds of the sale of the property at the end of the holding period (reversion), or through a combination of the two. Property characteristics and the income stream pattern impact investor behavior and, therefore, the applicability of the various capitalization methods for a specific property.

One of the most common Direct income capitalization methods uses an Overall (capitalization) Rate. The preferred method of *Overall Rate* derivation is from an analysis of comparable sales and their relationship between net income and sales price. The appraiser analyzes each comparison property's sales price, rents, expenses, net income and Overall Rate, makes needed adjustments and selects an appropriate indicated Overall Rate for the property being appraised. This rate represents both the return *on* and the return *of* the investment. To ensure reliability of the selected rate, the appraiser uses judgment and experience to make certain the comparables and the subject property have similar age, physical, location, income, expense and risk characteristics.

The Overall Rate Formula

To find the indicated value of income property, divide the net annual income by the Overall Rate:

$$\text{Net Annual Income} \div \text{Overall Rate} = \text{Property Value}$$

or

$$I \div R = V$$

If any two factors in this formula are known, the third can be obtained.

$$I = R \times V$$

and

$$R = I \div V$$

INCOME APPROACH PROCESS

The main steps to Direct capitalization using an Overall Rate:

- Determine the net annual income;
- Select the appropriate cap rate by market comparisons; and
- Capitalize the income (divide the net annual income by the cap rate).

Determining Net Annual Income

The procedures for determining net annual income are:

- Estimate potential gross income the property is capable of producing.
- Deduct from potential gross income an annual allowance for vacancy factor and rent collection loss. The remainder is called the “effective” gross income.
- Deduct from effective gross income the estimated probable future annual expenses of operation (fixed expenses, variable expenses, reserves for replacements for building components or short-lived items) to obtain the net income of the investment property.

Income and expenses. The potential gross income used is the expected future income. In many cases, the immediate past or current income may be an indicator of future income. However, reliance solely upon past or current income is incorrect. The income to use is the one which a typical investor in the subject property would anticipate.

Income estimates. The gross income estimate for an income property is the potential or anticipated gross income from all sources (market rents, parking space fees, etc.). Contract rent is the actual, or contracted, rent received from the property. Market rent is the rent the property should bring in the open market. Rents and vacancy factors and collection losses are based on market rent data.

Rental data is obtained from the subject property’s rent schedule and the appraiser’s review of rents from similar properties in the area. The appropriate rent per unit of comparison (rent per square foot, rent per front foot, rent per apartment unit, etc.) of the comparables are compared with the subject property. Income and expenses are analyzed on an annual basis.

Expenses must be realistic. The operating expenses (all expenditures necessary to produce income) are to be deducted from the effective gross income to find the net operating income expected from the property. The appraiser must use caution in extracting expense information from owner’s operating statement as some items included on the operating statement, such as principal and interest payments on mortgages and depreciation allowance for income tax purposes, must be disregarded by the appraiser as not being allowable expense items.

Expenses are generally classified as being one of the following:

Fixed expenses. These are incurred annually and have little correlation to the level of occupancy. They are to be paid whether the property is fully occupied or not. These items include real property taxes, insurance, licenses and permits.

Variable expenses. These expenses are incurred continually in order to maintain and give service to the property. They are variable depending upon the extent of occupancy and include items such as utilities, management fees, security, costs of administration, maintenance and repairs for structures, grounds and parking area maintenance, contracted services (e.g., rubbish removal) and payroll.

Reserves for replacements. This is an annual allowance for replacing worn out equipment and short-lived building components, such as stoves, carpets, draperies, and roof covering.

Selecting the Overall Rate

The appraiser selects an appropriate Overall Rate after market analysis of similar property sales. This rate provides for return of invested capital plus a return on the investment.

The rate is dependent upon the return which investors will actually demand before they will be attracted by such an investment. The greater the risk of losing the investment, the higher will be the accompanying rate as

determined in the market for such properties. By analyzing market prices, the rate can be approximated at any given time.

A variation of only 1 percent may make a substantial difference in the capitalized value of the income.

For example, based on an annual net income of \$30,000, and an Overall Rate of 6 percent, the capitalized property valuation would be \$500,000 (income ÷ rate). Capitalizing this same income with an Overall Rate of 7 percent would result in a value of only \$428,500 (rounded).

Capitalizing Net Annual Operating Income

The final step after having determined the net annual income and the capitalization rate is to capitalize the income. This may be merely the mathematical calculation of dividing the income by the rate if the income is considered to be in perpetuity, as in Overall Rate analysis.

For example, the valuation of property which has an assumed perpetual annual net income of \$30,000 and a capitalization rate of 5 percent is \$600,000. The lower the rate, the greater the valuation, and the greater the assumed security of the investment.

INCOME APPROACH APPLIED

Using the Overall Rate procedures just discussed, here are two examples for finding estimated value using the Income Approach.

1. What is the market value of a 10 unit apartment house with an estimated market rent per unit of \$500 per month? The market vacancy and collection loss is 7%. The subject property expenses appear consistent with similar properties in the market and similar comparable sales indicate an Overall Rate of 8 percent. The Fixed expenses are: real property taxes of \$6,420 and insurance of \$860. Variable expenses are: management - \$3,960; utilities - \$1,200; waste removal - \$600; reserves for replacement - \$1,700 (roof \$800, painting \$500, carpeting \$400).

Potential Gross Income (Annual)		\$60,000
(10 x \$500 x 12 = \$60,000)		
Less Vacancy and Collection Loss		<u>4,200</u>
(.07 x \$60,000 = \$4,200)		
Effective Gross Income		55,800
Less Expenses		
Fixed		
Taxes	\$6,420	
Insurance	<u>860</u>	
Total		\$7,280
Variable		
Management	3,960	
Utilities	1,200	
Waste Removal	<u>600</u>	
Total		5,760
Reserves for Replacement		
Roof	800	
Painting	500	
Carpeting	<u>400</u>	
Total		1,700
SUBTRACT TOTAL OF EXPENSES		<u>-14,740</u>
NET OPERATING INCOME (NOI)		\$41,060

Overall Rate from analysis of comparable sales is 8%.

Using formula $I \div R = V$

$\$41,060 \div .08 = \$513,250$

Indicated Market Value (rounded) \$515,000

2. A small commercial building has a contract rent of \$276,500 annually and suffers vacancy/collection losses of 5%. Expenses include: real property taxes-\$22,300; utilities-\$8,500; roof reserve-\$15,000; insurance \$11,000; maintenance-\$20,000; repainting and fixture reserve-\$5,000; and management-\$20,000. The subject's rental rates, vacancy and collection losses, and operating expenses are within market norms for similar properties. The appraiser also finds that similar properties have Overall Rates ranging from 8.75% to 9.37%. Based on this market data the appraiser selects an indicated Overall Rate for the subject property of 9%. Using the Income Approach, what is the indicated value of the property?

Potential Gross Income (Annual) \$276,500

Less Vacancy and Collection Loss (5%) 13,825

Effective Gross Income 262,675

Less Expenses

Fixed

Taxes \$22,300

Insurance 11,000

Variable

Maintenance 20,000

Utilities 8,500

Management 20,000

Reserve for Replacements

(Roof, Repainting and Fixtures) 20,000

Subtract Total Expenses -101,800

Net Operating Income (NOI) 160,875

Indicated Overall Capitalization Rate 9%

$\$160,875 \div .09 = \$1,787,500$

Indicated market value (rounded) \$1,790,000

RESIDUAL TECHNIQUES

An income property may have components of **known** value, or of value that can be determined by another technique, and a component of **unknown** value referred to as the "residual". These components may be physical (land and improvements) or financial (mortgage and equity). Residual techniques employ Direct capitalization to separate the net income for the entire property into the net income necessary to support each property component. Direct capitalization may then be used to value the residual (unknown component) by dividing the net income necessary to support that component, by an appropriate market derived capitalization rate. The different components may, and often do, have different capitalization rates. One then adds the value of the known component and the residual component for the indication of total property value. Residual techniques have very limited use and only for special valuation problems. The examples below outline the process.

Building Residual Technique

If the value of the land is known and the value of the building (the residual) is unknown, the property's value may be determined by the building residual technique. This technique allocates the net income of the property to both land and building. The procedure is:

1. Multiply the known land value by the applicable Land capitalization rate to determine the income attributable to land only.

2. Deduct income to the land from total net income to determine the income attributable to the building.
3. Capitalize the building's income at the applicable Building Capitalization rate to derive the value of the building.
4. Add the capitalized value of the building to the land value to arrive at the value of the whole property.

Example. An appraiser forecasts the net annual income of a 60 unit apartment building at \$216,000. On the basis of several comparable sales, an appraiser estimates that the land value is \$60,000 and that the applicable Land capitalization rate and the Building capitalization rate are 8% and 12%, respectively. What is the indicated value of the property by the income approach?

Annual net income of property	\$216,000
Less the income attributable to the land (\$60,000 x 8%).....	<u>4,800</u>
Net income attributable to building	\$211,200
Indicated building value (\$211,200 ÷ .12)	\$1,760,000
Plus Land value (by Sale Comparison)	<u>60,000</u>
Indicated property value	\$1,820,000

Land Residual Technique

If the building value is known and the land value is unknown and cannot be determined by another method, the value of the property as a whole may be estimated by using the land residual technique. The land residual technique is similar to the building residual technique except that the appraiser must first find the income attributable to the improvements and the residual balance of the income is then attributable to the land. The procedure is:

1. Multiply the known improvement value by the applicable Building capitalization rate to determine the income attributable to the building only.
2. Deduct income to the building from the total net income to determine the residual balance of the net income attributable to/earned by the land.
3. Capitalize the land's income at the Land capitalization rate to derive the value of the land.
4. Add the capitalized value of the land to the building value to arrive at the value of the whole property by the land residual technique.

Example. Same facts as the building residual technique example above.

Annual net income of property	\$216,000
Less income attributable to building (\$1,760,000 x .12)	<u>211,200</u>
Net income attributable to land	4,800
Indicated land value (\$4,800 ÷ .08)	60,000
Building value	<u>1,760,000</u>
Property value indicated by land residual technique	\$1,820,000

Finding the Building Capitalization Rate - Example

A property sells for \$250,000. Building value is \$190,000. Remaining economic life is 25 years. Annual net income from building is \$28,000. What is the interest rate on the land and the building investment? What is the Building capitalization rate?

Recapture rate is 4% (100% ÷ 25).	
Building's net income	\$28,000
Recapture of building (.04 x \$190,000)	<u>\$7,600</u>
Net income after recapture	\$20,400

Interest rate on land and building = $\$20,400 \div \$190,000 = .1074$ or 10.74%

The overall cap rate is the sum of the interest rate (return on) and recapture rate (return of):

Interest Rate = 10.74%

Recapture Rate = 4%

Therefore, the Building capitalization rate = 14.74%

Or: The Building capitalization rate equals the net income to the building divided by the value of the building:

$$\$28,000/\$190,000 = 14.74\%$$

YIELD CAPITALIZATION ANALYSIS

Yield capitalization analysis is a method of converting economic benefits of ownership into present value by discounting each anticipated benefit at an appropriate yield rate, or by developing an overall capitalization rate that explicitly reflects the required yield rate and anticipated changes in income and/or value, if any. This method simulates typical investor assumptions by using formulas that calculate the present value of future economic benefits based on specified rate of return requirements.

The future economic benefits that are typically considered in this analysis are periodic cash flows and reversion. The procedure used to convert these future economic benefits into present value is called *discounting*, and the required rate of return (or yield rate) is referred to as the *discount rate*. The discounting procedure is based on the assumption that the investor will receive an adequate rate of return *on* the investment, plus return *of* the capital invested. Unlike Direct capitalization using market-extracted rates, the method and timing of the returns on and of capital are explicit in yield capitalization analysis. This valuation method can be used to value the fee simple interest in a property, or any property interest for which all future economic benefits can be estimated.

The most common form of Yield capitalization analysis is called *discounted cash flow analysis*. In this valuation technique, each anticipated future economic benefit of ownership of the property or property interest being valued must be estimated. Next, each benefit is discounted to present value using a discount rate that reflects the risk associated with the characteristics of the investment. This rate must be based on market attitudes and expectations for rates of return for similar assets. Yield rates inherently include a safe, risk-free rate, along with premiums to compensate the investor for the added risk, illiquidity, and burden of management associated with the specific investment. The safe rate included in the yield rate includes an inflationary expectation for the anticipated term of the investment. Finally, the present value of each future income benefit is summed for the total present value of the property.

The following discounted cash flow analysis example summarizes the application of Yield capitalization analysis to a simple real estate problem. The property to be appraised is expected to produce a first-year net operating income of \$100,000, which is expected to increase at 3 percent per year over a seven-year holding period. At the end of the holding period, it is anticipated that the property can be sold for \$1,000,000 net of sales expenses. The appropriate yield rate for this investment is concluded to be 13 percent. The following table shows the anticipated cash flows, along with the present value factors and the calculated present value of each year's cash flow.

Discounted Cash Flow Analysis

	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>	<i>Year 6</i>	<i>Year 7</i>
Net oper income	\$100,000	\$103,000	\$106,090	\$109,273	\$112,551	\$115,927	\$119,405
Reversion							<u>\$1,000,000</u>
Total inc	\$100,000	\$103,000	\$106,090	\$109,273	\$112,551	\$115,927	\$1,119,405
Present val factor	<u>x 0.8850</u>	<u>x 0.7831</u>	<u>x 0.6931</u>	<u>x 0.6133</u>	<u>x 0.5428</u>	<u>x 0.4803</u>	<u>x 0.4521</u>
Present value	\$88,500	\$80,659	\$73,531	\$67,017	\$61,093	\$55,680	\$475,859

TOTAL PRESENT VALUE: \$902,339; rounded to \$900,000.

(The present value factors in this analysis were calculated using a financial calculator, but could have been obtained from a set of financial tables.)

GROSS RENT AND GROSS INCOME MULTIPLIERS

The Income Approach methods discussed previously involved the capitalization of net income. However, typical investors in certain types of income properties analyze and purchase them on a gross, rather than net, income basis. Gross Rent Multiplier (GRM) and Gross Income Multiplier (GIM) analyses are also Direct capitalization techniques that convert a projected single year income to an indication of value.

This discussion and the example below focus on the Gross Rent Multiplier (GRM) which involves the analysis of the gross rents attributed to a property. However, many properties derive income from sources in addition to rent (parking fees, etc.). When these additional sources of income are considered significant by typical potential investors in the property, then analysis of the Gross Income Multiplier (GIM) is appropriate. The Gross Income Multiplier (GIM) includes the analysis of all gross income generated by the property. GRM's and GIM's may be derived on either a monthly or annual basis, but must be applied consistently to the gross income of the subject property.

When deriving a GRM or GIM from a comparable sale, use caution if the income generated at the time of sale was not consistent with the market. If the property sold with rents **not** at market rates, than an effective GRM or GIM should be calculated by using market rental instead of actual (non-market) rents

The Gross Rent Multiplier is found by dividing the sales price of an income property by its monthly rent. For example: a \$90,000 sales price divided by a monthly rent of \$600 results in a gross rent multiplier of 150. If homes in the area were selling at prices equivalent to 150 times the monthly rental, then the 150 multiplier would apply to other comparable homes in the area.

Steps In Using the Gross Rent Multiplier

1. Determine the market rent of the property being appraised by comparison with similar rental properties.
2. The Gross Rent Multipliers of the sales one investigates are calculated by dividing the sales prices by the monthly rents.
3. The rent multipliers may then be tabulated showing how these properties varied from the subject property: i.e., better or poorer.
4. The Gross Rent Multipliers are *not* averaged to arrive at one final multiplier. Rather,
 - a. each property and its multiplier is compared to the subject property as to market rent, location, size, condition, utility, and amenities; and
 - b. after proper analysis, a judgment is made as to the appropriate Gross Rent Multiplier.
5. The appraiser multiplies the selected Gross Rent Multiplier by the market rental of the subject property. The product is the value estimate.

RECONCILIATION

Once the Sales Comparison, Cost, and/or Income Approaches to value have been completed, the indication of value by each must be reconciled to a final opinion of value. A thorough review of each of the approaches is made in order to ensure accuracy and consistency. If the results from one particular approach appear to be at a great divergence from the other(s), then each phase of this approach should be reconsidered to account for the difference.

The final opinion of value is not an average of the approaches employed. Instead, greater weight is generally given to one of the approaches over the other(s) based on the quantity and quality of the available data and the relevance of the approach to the appraisal assignment. Relevance is impacted by the intended use of the appraisal, the subject property type, and the actions of market participants for similar properties. After giving full consideration to each approach, the appraiser uses judgment and reasoning to arrive at a final opinion of value.

The final opinion of value should not be reported in odd dollars and cents as that would imply a level of precision not generally supported by market data. Instead, the opinion of value should be rounded.

APPRAISAL OF MANUFACTURED HOMES AND MOBILE HOMES

There is a distinction between manufactured and mobile homes. Manufactured homes are factory-built to the Housing and Urban Development Title 6 Construction Standards, commonly referred to as the HUD Code, on or after June 15, 1976. Mobile homes were factory built prior to the enactment of the HUD Code, and are often referred to as “pre-HUD Code” or “trailer” homes.

An initial consideration is the classification of the unit as either real or personal property. Real property status may be verified by the manner of attachment to the site and whether certain forms have been recorded in the County where the unit is located. A recorded California Department of Housing and Community Development (HCD) form number 433A confirms that a manufactured home on private property was affixed to an approved foundation as certified by a California licensed engineer, and that the manufactured home is no longer personal property.

The valuation approaches outlined for other residential properties are applicable in the appraisal of manufactured and mobile homes attached to foundations on individual lots. The Sales Comparison Approach is often the most applicable valuation approach for these properties.

In many circumstances, the appraisal of a manufactured or mobile home on a fee-owned space is similar to residential planned unit development appraisal. This includes consideration of homeowner’s association services and fees as well as CC&Rs covering operation of the park and space improvement requirements.

Mobile home appraisal is becoming another specialized opportunity in the appraisal profession. This is particularly true in the expanded market for mobile homes as low and moderate income housing.

APPRAISING SINGLE FAMILY RESIDENCES AND SMALL MULTI-FAMILY DWELLINGS

This section outlines basic premises which must be considered in making an appraisal of a single family residence and emphasizes some important factors to be weighed. It points out the differences that will be encountered between appraising new and used homes, and shows appraisal differences between a small multi-family dwelling and a single family home.

Single Family Residence

Neighborhood analysis.

- A. Factors which make up the neighborhood must be determined and analyzed.
 1. Type of occupants.
 - a. Income level.
 - b. Representative age groups and family sizes.
 - c. Owner occupancy vs. non-owner occupancy levels
 2. Type of improvement.
 - a. Is there a mixture of uses (e.g., single family, apartments, etc.)?
 - b. What is the age bracket of the improvements?
 - c. What is the price range of typical houses in the area?
 - d. Conformity of the neighborhood
 3. Neighborhood trend.
 - a. Are there detrimental factors present which might tend to depress the market?
 - b. Is the trend away from single family houses to multi-family, commercial or industrial uses?
 - c. Is the neighborhood in a transitional stage from owner occupied homes to tenant occupancy?
 - d. Are there advantageous factors which indicate an increasing market demand or price level?
 - e. What stage is the neighborhood in the neighborhood life cycle?
 4. Changes in land use.
 - a. Zoning and restrictions.
 - b. Street and highway pattern.
 - c. Transportation.
 - d. Any encroachments?
 - e. Is utility increased? Decreased?

5. Community services.
 - a. Commercial.
 - b. Recreational.
 - c. Educational.
 - d. Cultural.
 - e. Governmental.

Inspection of property.

- A. Relationship of the improvements to site.
 1. The house, including outbuildings, should have a harmonious appearance on the site.
 - a. Is the house too large for the site?
 - b. Is the house properly oriented on the lot to take advantage of climatic conditions?
 - c. Overbuilt? Underbuilt?
- B. Exterior of house.
 1. Determine the quality of construction. Inspect:
 - a. Foundation.
 - b. Walls.
 - c. Roof.
 2. Determine the resistance to wear and tear and the action of the elements.
 - a. Are there adequate gutters and drainspouts to take the water away from buildings?
 - b. Are there satisfactory roof overhangs to protect the windows and walls?
 3. Measure the exterior dimensions of the buildings in order to obtain their areas.
 4. Examine and describe yard improvements for purposes of estimating their value.
- C. Interior of house.
 1. Determine the quality of the building.
 - a. Durability of building.
 - b. Arrangement of floor plan and layout of space.
 - c. Attractiveness of design.
 - d. Grade and quality of materials used.
 - e. Adequacy of heating, cooking, electrical, and plumbing equipment.
 2. Measure or take note of room sizes and placement of windows for adequate light and ventilation.
 3. Determine if the traffic pattern is functionally proper.
 4. Does the home have all the modern conveniences necessary for a new house in its price class?

Verification through public records.

- A. Public records should be checked to verify the following about the property being appraised:
 1. Proper legal description.
 2. Correct street address.
 3. Size/dimensions of the lot.
 4. Location of the lot with respect to the nearest cross street.
 5. Any easements, restrictions or other reservations or interests affecting the property.
 6. The Assessor Parcel Number, assessed value and taxes of the property.
 7. Any changes in zoning or street pattern.
- B. Transfer of title of similar properties.
 1. Sales of single family vacant lots should be obtained and verified.
 2. Sales of improved single family residences within the same neighborhood should be recorded.

Inspection of comparable sales.

- A. Vacant lots or improved similar properties should be inspected from at least the street.

- B. Similar or dissimilar features as compared to the subject property are recorded and the selling price, terms and reasons for sale or purchase must be verified by the seller or buyer.

Application of approaches to value.

- A. Cost approach to value.
1. From the information gathered in the inspection and the size, quality and cost classification, an estimate of cost is made of all improvements on the land.
 2. The land value is estimated from information gathered in the record search of vacant parcels.
 3. In the majority of instances, if the improvements are new and the highest and best use of the land, the estimate of value by means of the cost approach is equal to land value plus the new improvement costs.
- B. Sales Comparison or market approach to value.
1. The sales of similar type houses are compared to the subject as to time, location and physical characteristics.
 2. Necessary adjustment must be made between the sales and the subject.
 3. A preliminary estimate of value by means of the comparative approach is obtained.
- C. Income approach to value, if applicable (if there are rentals in this neighborhood).
1. The market rent of the subject is estimated by means of experience and comparison.
 2. Gross monthly multipliers of similar type properties are gathered and analyzed in order to arrive at one multiplier to apply to the subject.
 3. A preliminary estimate of value by means of the income approach is obtained.
- D. Reconciliation of the approaches.
1. Each approach is weighed and compared.
 2. With a new property it will generally be found that the cost approach will be more applicable than for an older property due to the difficulty in estimating accrued depreciation.
 3. If the new subject property were located within a tract of similar type houses, market comparison would be given the most weight in the reconciliation.
 4. After weighing all of the factors involved, one final value reconciliation for the property is set forth.

Definition of small multi-family dwelling.

- A. In most instances, a small multi-family dwelling refers to a property which contains two to four living units. These units may be one of the following:
1. Double bungalow or duplex.
 2. Triple bungalow or triplex.
 3. Small courts or numerous houses on a lot.
 4. Four unit or fourplex.

Reasons for purchasing residential properties.

There are three categories of residential properties: (1) Single family homes; (2) Small multiple family dwellings; and (3) Income producing multiple family dwellings. They can be described as follows:.

- A. Owner occupied single family homes.
1. Primary concern is given to amenities of home ownership.
 2. Cost of ownership is of secondary importance.
 3. Pride of location and architectural appeal is given consideration before purchasing.
- B. Small multi-family dwellings and rented single family residences are purchased for a combination of property ownership and income.
1. Location, architectural attractiveness, and the amenities of ownership are given strong consideration by a purchaser.
 2. Income and tax benefits are strongly considered.
 3. Sometimes, a buyer will live in one unit in a small multi-family dwelling with the intention of reducing the cost of living by obtaining some rental income.
 4. The income received may offset real estate taxes, insurance, and maintenance costs.
 5. Rental income may also cover mortgage payments on the property.
 6. Many times, the owner of a small multi-family dwelling will manage the property.

- C. Income producing multi-family dwelling.
 - 1. Large multi-family dwellings (above 10 to 15 units) are purchased primarily for the income stream to be produced.
 - 2. The net income or spendable income is the most important item considered by the buyer.
 - 3. Amenities of ownership have little influence in the buying decision.
 - 4. Buyers look for a hedge against inflation.
 - 5. Chance for appreciation in value due to increasing demand in the area..
 - 6. Tax benefits

Appraisal procedure for small residential income properties and single family residences.

- A. Small multi-family units are appraised approximately the same as single family homes that have sufficient rental data to perform an Income Approach to value..
- B. Cost factors, depreciation and estimates of land value are calculated in the same manner as with single family homes.
- C. Small units normally are appraised using monthly gross multipliers. Income Capitalization methods are not normally employed.
- D. The Sales Comparison Approach differs for small multi-family dwellings from the Sales Comparison Approach applied to single family homes.
 - 1. Less emphasis is placed on attempting to measure pride of ownership and amenities in a small multi-family dwelling.
 - 2. The units of comparison can be refined to a greater degree.
 - a. Comparisons may be made on a per unit basis.
 - b. Comparison can be made on a per room basis.
 - 3. The appeal of the units from a renter's standpoint must be considered.

Amenities of multi-family dwellings.

- A. Factors and amenities considered important by tenants of multi-family dwellings.
 - 1. Distance from employment centers.
 - 2. Public transportation.
 - 3. Distance to good shopping.
 - 4. Distance to parks and recreation.
 - 5. Distance from nuisances.
 - 6. Rent levels.
 - 7. Pride of ownership.
 - 8. Adequacy of off-street parking.
- B. Factors considered important by the owner.
 - 1. Police and fire protection, rubbish collection.
 - 2. Vacancy rates in the area.
 - 3. Amount of taxes.
 - 4. Possible rent control ordinances.

ADDITIONAL PRACTICE PROBLEMS

The following are some additional practice problems with suggested solutions.

Applying the Income (Capitalization) Approach

- 1. A 50 unit apartment building and lot are being appraised. The 30 two-bedroom units rent for \$600 and the 20 one-bedroom units rent for \$475 monthly, which rent is comparable to market rent in the area. Vacancy and collection losses are estimated to be 5% of potential gross income. The parking structure and laundry facility contribute an additional estimated \$1,200 income per month. What is the property's (land and building) total estimated annual effective gross income?

Solution.

30 x \$600 = \$18,000 x 12 =	\$216,000
20 x \$475 = \$9,500 x 12 =	<u>114,000</u>
Apartment rental income.	\$330,000
Plus other income: \$1200 x 12 =	<u>14,400</u>
Potential Gross Annual Income	\$344,400
Less 5% vacancy/collection loss	<u>-17,220</u>
Total annual effective gross income	\$327,180

2. The owner's operating statement shows the following annual expenses:

FIXED EXPENSES

Real Property Taxes	\$31,500
Insurance	2,200
License	200
Capital Improvements	22,000
Depreciation	<u>10,000</u>
	\$65,900

VARIABLE EXPENSES

Water	\$9,000
Gas and Electricity	6,000
Pool Service	4,800
Gardening Maintenance	1,200
Entertainment Expenses	750
Building Maintenance	10,000
Resident Manager Salary	12,000
Refuse Service	<u>1,200</u>
	\$44,950

RESERVES FOR REPLACEMENTS

Appliances, carpets, drapes	\$6,000
Building components	<u>4,000</u>
	<u>\$10,000</u>

TOTAL EXPENSES..... \$120,850

After reconstructing owner's statement (determining proper allowable expense items), what is property's annual estimated net income?

Solution.

Deduct \$32,000 (Capital Improvements and Depreciation) from fixed expenses and \$750 (Entertainment Expense) from variable expense, as being improper deductions.

From problem #1, the effective annual gross income is \$327,180

EXPENSES

FIXED	\$33,900
VARIABLE	44,200
REPLACEMENT RESERVES	<u>10,000</u>
TOTAL EXPENSES	<u>- 88,100</u>

ESTIMATED ANNUAL NET INCOME OF PROPERTY \$239,080

3. The appraiser determined a proper overall capitalization rate for the above property is 9.5%. What is the estimated property value?

Solution.

\$239,080 net income ÷ .095 cap rate = \$2,516,632 estimated property value rounded to \$2,500,000.

THE OFFICE OF REAL ESTATE APPRAISERS

Background

In 1989, Congress passed the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), commonly known as the “Savings and Loan Bailout Bill.” Title XI of FIRREA contains the *Real Estate Appraisal Reform Amendments* which require each state to establish a program to license and certify real estate appraisers who perform appraisals for federally related transactions. Title XI additionally requires states to adhere to real estate appraiser qualifications criteria set by the Appraiser Qualifications Board (AQB) of The Appraisal Foundation.

Office of Real Estate Appraisers

In response to FIRREA, in 1990 the California Legislature enacted the Real Estate Appraisers’ Licensing and Certification Law (Business and Professions Code Section 11300, et seq.) This law created the Office of Real Estate Appraisers (OREA), which was organized in early 1991. OREA regulates real estate appraisers by issuing licenses and investigating complaints of illegal or unethical activity by licensed appraisers.

Real Estate Appraiser Licenses

There are four levels of licensing for real estate appraisers in California. Listed below are the requirements for each of the four levels.

- 1. Certified General Real Estate Appraiser** — Certified general appraisers may appraise any type of real property.

Education — At least 300 hours of appraisal related education covering these specific required core curriculum modules which are required by AQB:

Basic Appraisal Principles	30 hrs
Basic Appraisal Procedures	30 hrs
The 15-Hour National USPAP Course or its Equivalent	15 hrs
General Appraiser Market Analysis and Highest and Best Use	30 hrs
Statistics, Modeling and Finance	15 hrs
General Appraiser Sales Comparison Approach	30 hrs
General Appraiser Site Valuation and Cost Approach	30 hrs
General Appraiser Income Approach	60 hrs
General Appraiser Report Writing and Case Studies	30 hrs
Appraisal Subject Matter Electives	30 hrs

(May include hours over minimum shown above in other modules)

and

a Bachelors Degree from a Regionally Accredited College or University. In lieu of the Bachelors Degree, an applicant can complete 30 college semester credits in courses covering the following specific subject matters:

English Composition; Micro Economics; Macro Economics; Finance; Algebra, Geometry or higher mathematics; Statistics; Introduction to Computers; and Business or Real Estate Law; and two elective courses in accounting, geography, ag-economics, business management, or real estate.

Experience — At least 3,000 hours of acceptable appraisal experience, of which at least 1,500 hours must be in appraising non-residential properties. The experience must have been obtained over a minimum of 30 months. Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review of an appraisal (400 hours maximum.)
- Appraisal analysis
- Real estate counseling

- Highest and best use analysis
- Feasibility analysis/study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience as a real estate lending officer or real estate broker.

Examination — Successful completion of the AQB endorsed Uniform State Certified General Real Property Appraiser Examination.

2. **Certified Residential Real Estate Appraiser** — Certified residential appraisers may appraise *any* one-to-four unit residential property, and non-residential property with transaction value up to \$250,000.

Education — At least 200 hours of appraisal related education covering these specific required core curriculum modules which are required by AQB:

Basic Appraisal Principles	30 hrs
Basic Appraisal Procedures	30 hrs
The 15-Hour National USPAP Course or its Equivalent	15 hrs
Residential Market Analysis and Highest and Best Use	15 hrs
Residential Appraiser Site Valuation and Cost Approach	15 hrs
Residential Sales Comparison and Income Approaches	30 hrs
Residential Report Writing and Case Studies	15 hrs
Statistics, Modeling and Finance	15 hrs
Advanced Residential Applications and Case Studies	15 hrs
Appraisal Subject Matter Electives	20 hrs
(May include hours over minimum shown above in other modules)	

and

an Associate Degree from a Regionally Accredited College. In lieu of the Associate Degree, an applicant can complete 21 college semester credits in courses covering the following specific subject matters:

English Composition; Principles of Economics (Micro or Macro); Finance; Algebra, Geometry or higher mathematics; Statistics; Introduction to Computers; and Business or Real Estate Law.

Experience — At least 2,500 hours of acceptable appraisal experience. The experience must have been obtained over a minimum of 30 months. Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review of an appraisal (400 hours maximum.)
- Appraisal analysis
- Real estate counseling
- Highest and best use analysis
- Feasibility analysis/study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience as a real estate lending officer or real estate broker.

Examination — Successful completion of AQB endorsed Uniform State Certified Residential Real Property Appraiser Examination.

3. **Residential License** — Residential licensed appraisers may appraise any non-complex one-to-four unit residential property with a transaction value up to \$1 million, and non-residential property with a transaction value up to \$250,000.)

Education — At least 150 hours of appraisal related education covering these specific required core curriculum modules which are required by AQB:

Basic Appraisal Principles	30 hrs
Basic Appraisal Procedures	30 hrs
The 15-Hour National USPAP Course or its Equivalent	15 hrs
Residential Market Analysis and Highest and Best Use	15 hrs
Residential Appraiser Site valuation and Cost Approach	15 hrs
Residential Sales Comparison and Income Approaches	30 hrs
Residential Report Writing and Case Studies	15 hrs

Experience — At least 2,000 hours of acceptable appraisal experience. The experience must have been obtained over a minimum of 12 months. (Note that the holder of a valid California real estate broker license can qualify with 1,000 hours of acceptable appraisal experience. The Appraisers Qualification Board (AQB) has determined that a broker obtaining a license in this manner does not meet the minimum licensing criteria. AQB will identify the licensee on the National Registry as “Not AQB Compliant” until such time that the licensee has provided OREA with substantiation of having met the minimum requirement of 2,000 hours of acceptable experience.) Experience may be obtained in any of the following categories:

- Fee and staff appraisal
- Ad valorem tax appraisal
- Review appraisal
- Appraisal analysis (400 hours maximum.)
- Real estate counseling
- Highest and best use analysis
- Feasibility analysis and study
- Setting forth opinions of value of real property for tax purposes
- Assisting in the preparation of appraisals (400 hours maximum.)
- Real estate valuation experience as a real estate lending officer or real estate broker.

Examination — Successful completion of AQB endorsed Uniform State Residential Licensed Real Property Appraiser Examination.

4. **Trainee License** — (Trainee licensed appraisers must work under the technical supervision of a state Certified Residential or Certified General appraiser. They may assist on any appraisal which falls under the scope authorized for the supervising appraiser. NOTE: No supervising appraiser may supervise more than three trainees at any time.)

Education — Same as Residential License

Experience — No experience is required for the Trainee License. To accumulate appraisal experience, trainees must work under the technical supervision of a state licensed appraiser.

Examination — Successful completion of AQB endorsed Uniform State Residential Licensed Real Property Appraiser Examination.

Terms of Licenses

Real estate appraiser licenses are valid for two years; however, proof of the required 56 hours of continuing education is submitted every four years.

Renewal Requirements

All licensed appraisers must complete an average of 14 hours of continuing education per year of the license term for license renewal, including the following specific continuing education requirements:

USPAP — Each licensee must complete the 7-hour National USPAP Update Course (or its equivalent as determined by the AQB) every two years, and must submit proof of completion every two years. The course must be taught by an AQB Certified USPAP Instructor who is a Certified Residential or Certified General appraiser in good standing.

Laws and Regulations — Each licensee must complete the 4-hour course entitled Federal and State Laws and Regulations during the four-year cycle, or licensees may certify that they have read and understand all applicable federal and state laws and regulations. Such certification does not provide a 4-hour “credit” towards the required hours of continuing education .

Proof of completion of the remaining continuing education courses is required every four years. Applicants for license renewal must complete a total of 56 hours of continuing education during the four-year cycle .

OREA’s Enforcement Division

The Enforcement Division is OREA’s investigative and enforcement arm. It promotes professionalism in the industry by providing consumers and businesses with protection against unlawful and fraudulent conduct by appraisers. This is accomplished through the examination of past conduct of applicants for licensure, the investigation of complaints and, where appropriate, the initiation of proceedings to deny licenses or impose disciplinary sanctions. Subject to various administrative safeguards and the review and approval of the Chief Deputy Director and the Director, the Division may seek to deny, restrict or revoke a license and/or impose a fine of up to \$10,000 for each violation of state law applicable to licensed appraisers.

Additional Information

For additional information, write or call OREA at:

Office of Real Estate Appraisers
1102 Q Street, Suite 4100
Sacramento, CA 95811
(916) 552-9000

Web site address: www.orea.ca.gov