Modern Real Estate Practice in Illinois, 6th Edition
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Chapter 19: Real Estate Appraisal

Learning Objectives

After reading this chapter, students should be able to:

- Identify the different types and basic principles of value.
- Describe the three basic valuation approaches used by appraisers.
- Explain the steps in the appraisal process.
- Distinguish the four methods of determining reproduction or replacement cost.
- Define the following key terms: anticipation; appraisal; appraiser; assemblage; capitalization rate; change; competition; conformity; contribution; cost approach; depreciation; economic life; external obsolescence; FIRREA; functional obsolescence; gross income multiplier; gross rent multiplier; highest and best use; income approach; increasing returns; index method; law of diminishing returns; market value; physical deterioration; plottage; progression; quantity-survey method; reconciliation; regression; replacement cost; reproduction cost; sales comparison approach; square-foot method; straight-line method; substitution; supply and demand; unit-in-place method; and value.

Why Learn About Appraisal?

Appraisal is a distinct area of specialization within the world of real estate professions. However, even real estate licensees who are not professional appraisers need to understand the fundamental principles of valuation in order to complete an accurate, effective competitive market analysis (CMA) for their seller clients. Further, an understanding of the appraisal process will help you more clearly anticipate the likely outcome (and plan to avoid potential pitfalls) of a property's pre-closing appraisal.

Suggested Items to Bring To Class

1. Blank copies of the Uniform Residential Appraisal Report (URAR).
2. Sample appraisal reports, including certificate or letter reports, form reports (URAR reports, for example), and narrative reports.
3. Copies of competitive market analyses so your students can see that CMAs do not constitute appraisals but are merely analyses of sales activity.

4. Samples of sales data that could be used in a competitive market analysis or in the sales comparison analysis of an appraisal, such as a multiple listing service summary of sales activity, a market data report, etc.
5. Copies of the application documents and other forms used for appraiser licensing and certification.

Lecture Outline

I. Appraising

An appraisal is an estimate or opinion of value based on supportable evidence and approved methods.

- Appraising is a professional service performed for a fee.

A. Regulation of Appraisal Activities

Title XI of FIRREA requires that any appraisal used in connection with a federally related transaction must be performed by a competent individual licensed or certified according to state law.

- A federally related transaction is any real estate-related financial transaction in which a federal financial institution or regulatory agency is involved.

IN ILLINOIS . . . *the Illinois Real Estate Appraiser Licensing Act of 2002 provides for the licensure and certification of Illinois appraisers. The law recognizes three categories of appraisers:*

1. *Associate real estate appraiser: entry level appraiser limited to appraisal of non-complex property having a transaction value under $1 million; all reports must be co-signed by a state certified residential real estate appraiser or state certified general real estate appraiser.*
2. *Certified residential real estate appraiser: qualified to appraise residential property of one unit to four units without regard to transaction value or complexity, but with restrictions in accordance with Title XI, USPAP, and criteria established by AQB.*
3. *Certified general appraiser: qualified to appraise all types of property without restrictions as to the scope of practice.*

Only individuals may be licensed or certified as appraisers. No corporation, partnership, firm or group may be certified or licensed as an appraiser. A certified or licensed appraiser may, however, sign appraisal reports on behalf of a business entity. Nothing in the license act prohibits a nonlicensed or noncertified individual from appraising real estate for compensation. Appraisal certification and licensing candidates must meet educational, qualification, examination and

experience requirements as well as comply with a fee structure and disciplinary rules.

B. Comparative Market Analysis

A report compiled from research of the marketplace, primarily similar properties that have been sold; used by a salesperson to assist a seller in establishing a price for a property.

- A comparative market analysis prepared by a real estate licensee is not an appraisal; however, it is one of the techniques used by licensed appraisers.

II. Value

To have value in the real estate market, a property must have the following characteristics:

- *Demand*: the need or desire for possession ownership, plus financial capacity
- *Utility*: usefulness for its intended purposes
- *Scarcity*: a finite supply
- *Transferability*: relative ease with which ownership rights are transferred from one person to another

A. Market Value

The most probable price that a property should bring in a fair sale:

- Competitive and open market
- Buyer and seller acting prudently and knowledgeably
- Price not affected by unusual circumstances

Essential factors in rendering an opinion of value:

- Arm's length transaction
- Buyer and seller unrelated and acting without undue pressure
- Buyer and seller well informed about the property
- A reasonable time for exposure in the open market
- Payment in cash or its equivalent
- Price represents normal consideration for the property sold

1. Market value versus market price

- Market value: an opinion of value based on an analysis of data
- Market price: what a property actually sells for — its sales price

2. Market value versus cost

Cost and market value may be the same, but cost is usually considered a historic fact: it is the price that was paid for the property previously.

B. Basic Principles of Value

1. Anticipation

Value is created by the expectation that certain events will occur.

2. Change

No physical or economic condition remains constant.

3. Competition

The interaction of supply and demand.

4. Conformity

Value is created when a property is in harmony with its surroundings.

5. Contribution

The value of any part of a property is measured by its effect on the value of the whole.

6. Highest and best use

The most profitable single use to which a property may be put. The use must be legal, financially feasible, physically possible, and maximally productive.

7. Increasing and diminishing returns

As long as money spent on improvements produces an increase in income or value, the law of increasing returns applies; when additional improvements do not increase income or value, the law of diminishing returns applies.

8. Plottage

Principle of Plottage: merging or consolidating adjacent lots into a single larger one produces a greater total value than the sum of the two sites valued separately.

9. Regression and progression

- Regression: the worth of a better quality property is adversely affected by the presence of a lesser quality property.
- Progression: the value of a modest home would be higher if it were located among larger, fancier properties.

10. Substitution

The maximum value of a property tends to be set by how much it would cost to purchase an equally desirable and valuable property.

11. Supply and demand

The value of a property depends on the number and price of properties available in the marketplace, the number of prospective purchasers, and the price buyers will pay.

III. The Three Approaches to Value

A. The Sales Comparison Approach

An estimate of value is obtained by comparing the property being appraised with recently sold comparable properties. The sales prices of the comparables must be adjusted for dissimilarities, including:

- Property rights
- Financing concessions
- Conditions of sale
- Date of sale
- Location
- Physical features and amenities

B. The Cost Approach

The cost approach consists of five steps:

- Estimate the current construction cost of the buildings and improvements.
- Estimate the amount of accrued depreciation resulting from the property's physical deterioration, functional obsolescence, and external depreciation.
- Deduct the accrued depreciation from the construction cost.
- Estimate the value of the land as if it were vacant and available to be put to its highest and best use.
- Add the estimated land value to the depreciated cost of the building and site improvements to arrive at the total property value.

1. Reproduction cost: construction cost at current prices of an exact duplicate

2. Replacement cost new: cost to construct an improvement similar to the subject property using current construction methods and materials, not necessarily a duplicate**.**

3. Determining reproduction or replacement cost new

- *Square-foot method*: cost per square foot of a recently built comparable structure is multiplied by the number of square feet (using exterior dimensions) in the building.
- *Unit-in-place method*: replacement cost is estimated based on the construction cost per unit of measure of individual building components, including material, labor, overhead, and builder's profit.
- *Quantity-survey method*: quantity and quality of all materials and labor are estimated on a unit cost basis. These factors are added to indirect costs to arrive at the total cost of the structure.
- *Index method*: a factor representing the percentage increase of construction costs up to the present time is applied to the original cost of the subject property.

4. Depreciation

Loss in value due to any cause. (Land does not depreciate.)

a. Curable or incurable

- Physical deterioration
- Functional obsolescence
- External obsolescence

b. Straight-line method

Depreciation assumed to occur at an even rate over a structure's economic life. The property's cost is divided by the number of years of its expected economic life to derive the amount of annual depreciation.

C. The Income Approach

Based on the present value of the rights to future income. An appraiser takes five steps:

- Estimate annual potential gross income.
- Deduct an appropriate allowance for vacancy and rent loss (= effective gross income).
- Deduct the annual operating expenses from the effective gross income to arrive at the annual net operating income (NOI).
- Estimate the price a typical investor would pay (capitalization rate).
- Apply the capitalization rate to the property's annual net operating income to arrive at the estimate of the property's value.

D. Reconciliation

The art of analyzing and effectively weighing the findings from the three approaches, culminating in the final opinion of value.

IV. THE APPRAISAL PROCESS

The key to an accurate appraisal lies in the methodical collection and analysis of data.

- *General data*: the nation, region, city, and neighborhood
- *Specific data*: details of the subject property and comparables
- *Data for each approach:* sales data, cost data, income and expense data.

A. Appraiser's Report

Once the approaches have been reconciled and an opinion of value has been reached, the appraiser prepares a report for the client.

Discussion Questions

1. Why must an appraiser also have a knowledge of general real estate concepts, financing, construction, and law?
2. Is appraising an art or a science?

CLASSROOM EXERCISES

1. Distribute blank copies of the Uniform Residential Appraisal Report to your students. Have them make notes on the forms regarding the three approaches to value as they are discussed in class.
2. Distribute blank copies of the URAR to your students and have them attempt to complete the form for the property they are currently living in. For those living in properties other than single-family residences (such as apartments), have them use the inside dimensions of their units when completing the form.