CHAPTER 15

INTRODUCTION TO REAL ESTATE APPRAISAL

Learning Objectives

After studying this chapter, a student should be able to:

- ☑ Describe the different purposes an appraisal may serve
- ☑ Define and state the relationship between ceiling price, floor price, and sale price
- ☑ Define value to the owner and market value, and the difference between an estimate of each
- ☑ Provide a suitable definition of market value
- ☑ Discuss redevelopment potential and identify a property's highest and best use
- ☑ Describe the factors affecting the demand and supply of real property, and how they impact on the value
- ☑ Provide examples of how real estate markets can be classified
- ☑ Identify potential sources of data, data collection, and analysis with respect to the subject property
- ☑ Briefly describe the three appraisal approaches, and provide examples of properties most suited to each
- ☑ Discuss options for reporting final value estimates: oral or written and the comparative market analysis (CMA)
- ☑ Explain the legal consideration for appraisers, the legal consequences resulting from a negligently prepared appraisal report, and how compensation may be awarded
- ☑ Discuss AVMs and the future of appraisal

INTRODUCTION

Real estate valuations are necessary where someone requires an expert's opinion of the value of real property, such as an investor seeking the value of the property to be acquired, a mortgage lender needing an estimate to assess the security for a loan application, or a registrant listing a property for sale. Property valuation is a systematic, logical approach to the establishment of value, following the appraisal process.

The *Dictionary of Real Estate Appraisal* defines an appraiser as one who is expected to perform valuation services competently and in a manner that is independent, impartial, and objective. This expectation applies equally to professional appraisers completing valuations for a fee and to registrants providing valuation advice in the course of assisting with real estate sales transactions. Note that this chapter refers to appraisers and valuators interchangeably.

appraiser
one who is expected to perform valuation services competently and in a manner that is independent, impartial, and objective

An *appraisal* (also called a property valuation) is an **estimate** – it is someone's opinion of value. There is a degree of subjectivity in every valuation report as the author is required to express an opinion. However, those opinions should be supported by a logical rationale, underpinned by an objective analysis of market information.

appraisal
an estimate of the value in real property

Need for Appraisals

Specialists are required in the valuation of real property because a general knowledge of real property markets is not sufficient given the scale and importance of these transactions. The flow of information concerning real property is limited and difficult to collect for the following reasons:

- The turnover rate for real property is low, meaning there are limited data sources and information available upon which to base an opinion of value.
- Every parcel of real property is distinct, unique, and heterogeneous, meaning property values cannot easily be standardized or generalized, and therefore expertise is necessary to differentiate among value influences.
- Real property is durable and long-lasting, meaning it may not be quick to respond to market pressures (e.g., once you have built a house, you

are probably stuck with it for a number of years even if your local market declines) and thus expertise is needed to account for changes over time.

- Real property markets are local, with real estate fixed in location. Similar to the impact of durability, real property can be affected by external influences from neighbouring properties. These are called *externalities*, which can be positive (e.g., a park being developed across the street) or negative (e.g., a noxious industrial use operating next door).

externality
factor separate from the property can affect the property's value, either in a positive or negative manner

Market participants often find it useful to have a real property expert help gather and interpret this information. Contrast this against stock market transactions, which rarely require appraisals because of the frequency of sales (i.e., there is a lot of new information to work with), the market is national or international, the product is homogeneous (e.g., one share of General Motors is identical to every other share of General Motors), and the individual share purchase decision is generally less significant than decisions concerning real property.

The subjective perspective of buyers and sellers varies in the housing market. A feature of a house that is extremely appealing to one party may be considered neutral or negative by another. For example, an in-ground swimming pool may be an attractive feature for a family with teenagers, but may be considered a nuisance and a potential danger for a family with young children. This is a reflection of the heterogeneous nature of every property and of the personal preferences of the buyers and sellers in the market. Valuation expertise can help interpret these subjective preferences into an objective estimate of real property's market value.

Licensing Requirements for Appraisers

Most provinces do not require appraisers to be licensed.[1] In BC, anyone may legally undertake appraisal work and charge a fee for the appraisal services. So that someone with little knowledge about real property markets could call themselves appraisers and provide an appraisal of a property. Real estate licensees might not consider themselves appraisers, but they certainly carry out some degree of appraisal work when a property is listed for sale or when advising a potential purchaser. However, there are also complex valuation assignments such as hotels, golf courses, and First Nations lands that require appraisers with extensive valuation training and knowledge. There are many individuals with many different skills providing appraisals, and so it is necessary to distinguish between uninformed estimates (guesses) of value and properly prepared appraisals.

Throughout this discussion, the term "appraisal" implies that the estimate of value is made by a person who has acquired the skill and knowledge necessary for the application of certain relevant principles. This person is called an *appraiser*. However, the Courts may conclude that even people without formal training as appraisers are responsible for their actions in the role of appraisal work. For example, the Courts may decide real estate licensees possess the necessary skills and training for appraisal work and are therefore, legally responsible for their estimates of value.

The lack of licensing requirements for appraisers does not imply that appraisal is either a new field or an area without organization. A number of institutional and private appraisal associations currently operate in Canada; for example, the Real Estate Institute of BC (REIBC) and the Appraisal Institute of Canada (AIC). The appraisal industry effectively regulates itself through these organizations, establishing recognized professional designations achieved through a combination of education and experience, and enforcing codes of conduct that standardize appraisal practice and protect professional integrity. There are a number of organizations that offer educational and training programs for real estate licensees that include appraisal in their programs.

As a Mortgage Broker...

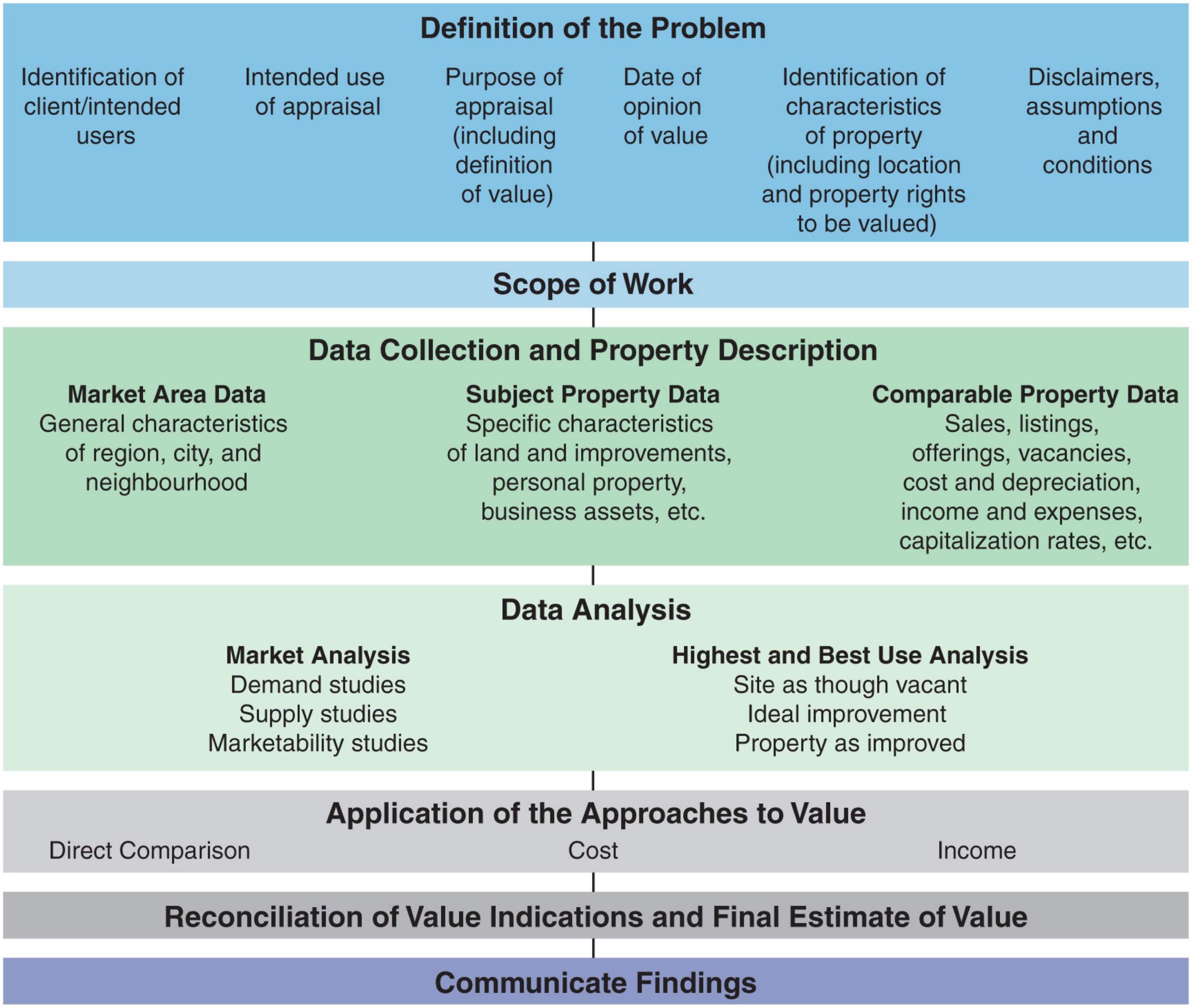
You will regularly come across appraisals, as many lenders demand confidence in the value of the loan's underlying security. The appraisers may belong to one of several appraisal organizations, but predominantly they will be from AIC. The AIC's designations are CRA (Canadian Residential Appraiser) and AACI (Accredited Appraisal Canadian Institute). Many lenders work with Appraisal Management Companies (AMCs) such as Centrac or Nationwide Appraisal Services (NAS). These services hire the appraisers and specify standards and processes for their work.

THE APPRAISAL PROCESS

Appraisers follow a logical, systematic process in valuing real property. This orderly approach structures the appraiser's work and ensures they consider all potential questions regarding the property and assignment. By comprehensively researching and analyzing answers to these questions, the appraiser produces a reliable, credible value estimate. Licensees providing value advice in their trading services role may not complete the same degree of comprehensive research and analysis as a professional appraiser. However, they will still benefit from following a systematic approach.

Figure 15.1 illustrates a generic overview of the appraisal process. This will be used as a framework for discussion in the rest of this chapter. While it appears that each step is quite separate from the other, in fact, they often overlap each other. This process may be applied formally or automatically, but it describes the approach commonly taken by most appraisers in valuing typical properties bought and sold in the real estate market. It is unlikely that one single method will cover every possible appraisal assignment, but the process described below should cover the appraisal problems commonly encountered.

FIGURE 15.1: The Appraisal Process



STEP 1: DEFINING THE APPRAISAL PROBLEM

The first step in the appraisal process is to clarify what is to be appraised and why. The appraiser defines the appraisal problem by considering:

- Client and intended users of the report
- Intended use of the valuation
- Purpose of the valuation, including the definition of value that is required
- Effective date of the report

- Characteristics of the property, including its location, legal description, and the property rights to be valued
- Disclaimers, extraordinary assumptions that are relevant to the report, and any limiting or hypothetical conditions upon which the estimate of value is based

Client and Intended Users of the Appraisal

The following lists some of the occasions when an appraisal may be required and who may need one:

- **Lending:** financial institutions, mortgage companies, banks, other lenders
- **Insurance:** real property insurance companies
- **Expropriation:** federal government, provincial government, organizations authorized by federal or provincial statute
- **Property taxation (assessment):** assessment authorities, property owners (disputing assessed values)
- **Real estate transactions (including listings for sale):** federal government, provincial government, other large organizations, developers, vendors, purchasers, real estate salespeople
- **Investments:** Real Estate Investment Trusts (REITs), pension fund investment companies, other investment companies
- **Financial records:** accountants, financial analysts, auditors, government organizations
- **Legal requirements such as estate, gift and transfer taxes, or divorce:** lawyers, parties with a legal interest in the real property, owners, property managers

Of particular note are recent changes in financial reporting. The *cost principle* requires that asset value be recorded at historic cost of acquisition. For real estate, this typically means setting initial book value as either the overall purchase price or the sum of the cost to construct plus land value. Depreciation is deducted annually (and any capital improvements are added over time). The International Financial Reporting Standards (IFRS) now require publicly traded companies to record asset values at their fair market value. This means appraising the value of a company's real estate holding quarterly or annually. Other Canadian businesses may voluntarily adopt this market value standard as well.

cost principle
a financial reporting principle requiring that asset value be recorded at its historic cost of acquisition

Intended Use and Purpose of the Appraisal

An appraiser needs to understand why the client has requested the appraisal. The purpose may be for:

- a *statutory* reason – for example, for expropriation or taxation purposes, where the valuator is guided by provisions outlined in relevant Acts; or
- a *market* reason – such as buying, selling, leasing, or developing a property, where the valuator may consider market data and is not forced to follow government statutes.

This information will help the appraiser determine what form of value needs to be determined, the type of market data required, and the potential constraints on the appraisal process.

Value Definitions: Objective, Subjective, and In Exchange

Estimating value is the object of an appraisal, but the word "value" may be defined differently in various contexts. For example, an appraiser's estimate of a property's *market value* may differ from how an owner perceives its value or the value in exchange or sale price. The interrelationship between sale price, *value to the owner*, and market value play a central role in the appraisal process.

market value
the price that might reasonably be expected to realize when sold by a willing seller to a willing buyer after adequate time and exposure to the market

Appraisers are typically called upon to estimate objective values, which in appraisal terms refers to a value that is determined based on market evidence and by applying generally accepted valuation techniques. Think back to the *objectivity principle* in Chapter 8 – similar to accounting, an appraised market value must be able to withstand an audit, where a third party is able to review the supporting documentation and understand the basis for the valuation decisions made. The objective values commonly estimated by appraisers may include *insurable* value, *lending* value, *taxable* value, or *actual (assessed)* value. *Market* value is the most common objective value estimated by appraisers. The definition of market value varies; however, in simple terms, market value can be defined as the expected sale price or forecasted sale price in a typical transaction.

Contrast this hypothetical market value estimate against the personal opinions of value held by individual owners, i.e., *value to the owner*, and buyers and sellers. Individuals each have their own subjective tastes, preferences, and biases. Given these highly personal characteristics, it is difficult for an appraiser to estimate subjective values. For this reason, appraisers tend to focus their work more in the objective realm. Appraisers do not commonly work with value to the owner or subjective values, but licensees' roles focus on it. A licensee might provide a market value estimate as a part of discussions with a client, but the listing price or offer price likely flows from a more subjective analysis. This distinction is important for licensees to understand in appropriately representing their clients' needs. In order for a sales transaction to occur, sale price must be at least equal to or more than the vendor's *floor price* and at most, equal to or less than the purchaser's *ceiling price.* This highlights a key difference between the valuation perspectives of appraisers and licensees – an example may help to illustrate this distinction.

value to the owner
the personal opinion of a property's value held by an individual owner; in appraisal, this refers to floor and ceiling prices, where owner includes a prospective owner

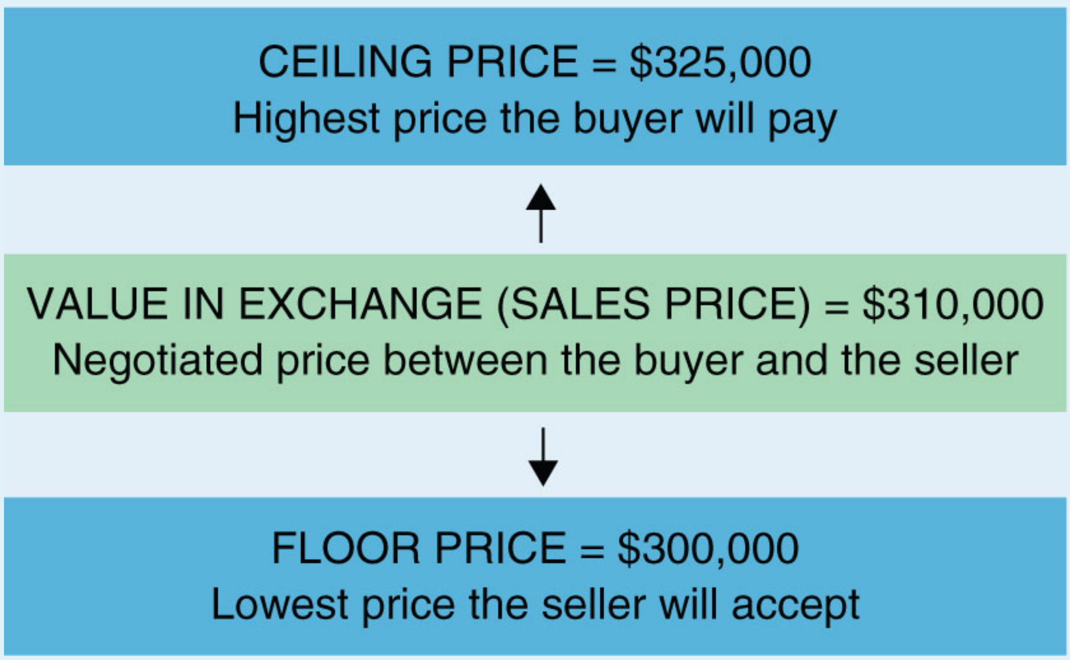
floor price
the minimum price at which a seller is willing to sell their property

ceiling price
the maximum price a purchaser is willing to pay for a property

Example

Consider a person who decides to sell his house: he will probably not sell at any price; he will only sell if he receives at least a certain minimum amount. The seller's minimum or *floor price*; is the lowest sum of money that he is prepared to accept and this will depend on how anxious he is to have cash. The prospective buyer's maximum or *ceiling price* is the price that she is prepared to pay. For a sale to occur there must be at least one potential buyer with an offer or ceiling price equal to, or greater than the present owner's floor price.

The seller's floor price is $300,000 and the buyer's ceiling price is $325,000. In negotiating, each will try to obtain the most favourable sales price. The seller is likely to start by asking a higher price than he is prepared to accept; and the buyer will make a counter-offer, until eventually a price of $310,000 is agreed upon: the sales price or *value in exchange*.



Two items should be noted from the transaction:

1. The seller is not likely to know the buyer's ceiling price and the buyer is usually unaware of the seller's floor price. This is the reason for negotiating the sale price.
2. The actual sale price they negotiate depends on their negotiating skills and how anxious they are to complete the transaction. If the seller has difficulty in finding a buyer, he may be willing to sell the house near or at his floor price. On the other hand, if this is the first offer, he may be willing to wait for a more attractive offer.

Floor and ceiling prices represent *value to the owner* (where "owner" includes both the current and prospective owner). It is impossible to accurately determine the value to the owner for either the buyer or seller if only the sale price is known. Usually sellers list the property for some time so that the minimum price may change over time, and buyers also have time to consider the purchase. Prices for both parties are not often definite; floor and ceiling prices exist in principle, but are not consciously calculated in all cases.

Where a property is withdrawn from the market and unsold, the vendor's floor price was greater than any prospective purchaser's ceiling price. The prospective buyer makes a series of offers, each higher than the last, but before reaching her ceiling price, this last offer is not accepted. She must either withdraw from the transaction or increase her ceiling price.

Substitute properties affect the actions of the prospective buyers. When prospective buyers state that a certain price for a particular parcel of land is their limit, they are suggesting they can buy another similar property for the same price. Consider a successful buyer who was prepared to pay more, or a seller who received more than what he was expecting versus a buyer who complains that she paid too much, or a seller who claims the property is worth more than what it was sold for. In the last two cases, did the buyer pay more than her ceiling price and did the seller sell for less than his floor price?

It may be that the disappointed buyer was overly optimistic in the property's returns or that another property was a better buy, and in the case of the disappointed seller, it may be a forced sale or a poor (and low) floor price estimate. Regardless, when a property trades at a particular price, the seller prefers cash to the property and the buyer would rather have the property than the cash.

Substitute properties determine the ceiling price and the eventual sale price of a house. Buyers view the benefits from a property differently and will not pay the same price for the same house. For example, one buyer may pay more for a house that is located next to a school, whereas another buyer may lower his ceiling price because it is next to a school.

As a licensee, it is important to be able to communicate the concept of value perception to clients. Buyers and sellers sometimes struggle with the idea that two different parties could value the same item so differently, arguing that their perceived value is "right" and that the other party is being unrealistic.

A common example is the perceived value added through home renovations. Sellers often want to recuperate at least the money invested in a home renovation, whereas the buyer might not agree that the renovation adds the same amount of value to the property as it cost to implement. And, if the renovation is not done to the buyer's personal tastes, if any value at all, was added. When a licensee properly explains the concept of perceived value to a property seller, the licensee is helping frame the seller's expectations for realistic offers. This, in turn, helps position the seller to approach the negotiation process with a more rational, less emotional mindset.

Definitions of Market Value

The definition of market value varies in legal decisions, real estate dictionaries, and books on appraisal. Although the wording differs, most definitions are similar in concept. Following are examples of some different definitions of market value:

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

   Canadian Uniform Standards of Professional Appraisal Practice

2. Market value is the estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently, and without compulsion.

   International Valuation Standards Committee

3. The amount that would have been paid for the interest if, at the time of its taking, it had been sold in the open market by a willing seller to a willing buyer.

Federal Expropriation Act

It is beyond the scope of this chapter to compare the various definitions of market value, but what should be noted is the element of subjective opinion required by the appraiser to determine what is fair, the degree of knowledge implied, and value to owner or a justified price. Meanings of these terms are difficult to support with market data but by recognizing that a sale price represents value (value in exchange) the appraiser's purpose is clear.

The following definition of market value is suggested:

> At any given time, the market value of an interest in land is the price it might reasonably be expected to realize when sold by a willing seller to a willing buyer after adequate time and exposure to the market.

The major points of this definition are:

- **Value is related to a certain point in time:** A change in value after the appraisal date will not necessarily invalidate the accuracy of the original appraisal.
- **Value is the price which might reasonably be expected:** Value is the expectation of someone who has sufficient knowledge of the real estate market to form an opinion; it is not the reasonable expectation of someone without this knowledge. It must be emphasized that "reasonably expected" does not infer that the appraiser considers the price to be reasonable.
- **Willing seller and willing buyer:** This means that both buyer and seller are negotiating in their own self-interest and neither party is exerting undue influence on the other. Nor is there any special relationship between them that would lead to a bargain at a price markedly different from the fair market value.
- **Adequate time and exposure to the market:** These terms must reflect market conditions and marketing practice as of the date of the appraisal.

This definition covers a large number of transactions and generally excludes only:

- sales in which there is a special relationship between buyer and seller;
- sales in which one party is exerting undue influence over the other in the transaction; and
- unusual prices due to an odd combination of circumstances that result in prices beyond any reasonable expectation and are not likely to recur with any frequency.

The main reasons for the adoption of this particular definition of market value are because:

- It is objective. The appraiser is not required to determine whether the price is justified economically or to assume degrees of knowledge of buyers and sellers.
- It can be applied to a large proportion of past transactions. Hence, it is practical to collect evidence of value from past market transactions.
- It applies to a large number of appraisal situations.

Objective Value

A negotiated sale price is a step away from a subjective value, but may still reflect the buyer and seller's biases and personal preferences of value. An appraiser can provide an objective estimate of market value, as a third party who is distanced from the negotiations, unbiased and unemotional. Along with a market value conclusion, the appraiser will also state the "reasonable exposure time", or how long the property would typically take to sell at that price.

Factors Influencing Market Value

Various factors can create, maintain, modify, destroy, or otherwise influence the value of real estate:

- **Economic:** trends in commerce and industry, interest rates, unemployment rates, wage levels, availability of money and credit, price levels, tax burdens, etc.
- **Political/government:** zoning bylaws, building codes, fire regulations, public health measures, rent controls, monetary policies including all forms of taxation, legislation, political upheaval or stability, government housing programs, etc.

- **Social:** population growth/decline, shifts in population density, changes in the size of families, desire for recreation/education facilities and neighbourhood amenities, desire for privacy, pride leading to ostentation and show in expensive homes, etc.
- **Physical:** created either by nature or by people including topography, soil fertility, climate, location, flood control, soil conservation, and community factors such as transportation, schools, churches, parks, and recreation areas.

Value to the Owner vs. Investment

An appraisal to find the estimated sales price (or market value) is not the same as one made to determine whether that price (or value) is justified. The appraiser is not suggesting that they think the property is "worth" that amount or that any individual should buy or sell at that price. *Justification of the market price* is a separate problem and its solution does not depend on the definition of market value. If an appraiser is asked to estimate the price that a particular property might be bought or sold in an open market transaction, they will determine the market value. If asked whether an individual should buy or sell at that price, the appraiser is addressing a separate question involving value to the owner.

Justifying the price falls in the area of real estate investment counselling, not appraisal. Investment counselling relates more to the individual circumstances of the buyer (or seller) and to the value to the owner. If a client, is considering buying an apartment building for $2.5 million and asks an appraiser if the property can be expected to realize this price, the appraiser determines market value. However, if the client asks the appraiser if this is a reasonable price to pay, it is another question altogether. The appraiser might be of the opinion that the expected price of the apartment building is too high (or low) with regard to the future economic prospects of ownership, or that his client's requirements and tax position may make the price of $2.5 million too high or low. The appraiser is then attempting to find his client's ceiling price and is expected to use his own assessment of future returns and yields. It often happens that the estimate of value on this basis is much different from market value. There is no cause for concern so long as the two different concepts of value are kept in mind. Because these issues are not always kept separate in practice, appraisers should insist on precise instructions including a statement of the purpose of the appraisal.

In practice, misunderstandings tend to arise when a prospective buyer asks if a property is worth $X amount or if $X amount is a fair price. These types of questions can be ambiguous because even if the market value of a property is $X, in the eyes of the majority of buyers and sellers, one particular buyer may not believe the property is worth $X in their eyes.

Another confusing statement often made by appraisers and licensees is that building lots are selling at $Y per square foot but they are "worth only half this amount." In this case, "worth" is based on their own personal opinion of value, but the prices actually paid are a measure of value (value in exchange) by buyers who have obviously formed different opinions. What a property is worth depends on the personal preferences, tastes, and biases of the owner or prospective purchaser. To an appraiser, worth simply means what the property is most likely to sell for in a typical sale, given current market conditions.

As noted already, value to the owner is highly subjective and difficult for appraisers (or licensees) to estimate. However, investment analysis is one aspect of valuation where a personal value is calculated in an objective manner. In estimating the *investment value* for a particular investor or calculating the *justified investment price*, the appraiser will use the owner's tax status and the financing capabilities to determine a value specific to that investor. The resulting value to owner will likely differ from market value.

investment value
the value that is specific to a particular investor

Date of Valuation

The specific date of valuation is important since value can fluctuate over reasonably short periods of time. A change in the legal status of a property can result in a sudden and dramatic change in value. For example, change in a zoning bylaw or the introduction of rent controls can have a major and immediate impact on value. Every valuation must be made as of a specific date to identify the prevailing market forces and conditions, in terms of which value is estimated; this is the *effective date* of the valuation.

effective date
the specific date an evaluation is made, considering the prevailing market forces and conditions at that date

The most commonly required value is the current value of the property, but some assignments may require the value as of some historical date. For example, appraisals for expropriation, capital gains tax, fire loss, or estate taxes may provide the value as of a past date.

Identifying Property Characteristics

Market value is the product of two property elements:

1. Rights of ownership
2. The physical property in which those rights are vested

The physical characteristics of the property are the physical, tangible aspects of the real estate – its location and amenities, such as the quality and condition of the improvements. The legal rights of ownership are less visible to the layperson, but have a fundamental impact on property value. These legal rights are discussed in the following section.

Interests to be Valued

It is common to refer to the value of a house or the value of a store as if the physical property was the subject of appraisal. Someone might say: "the value of my house is $85,000," or an appraiser might use the expression: "I appraised that factory at $460,000." These phrases are used because they are brief and convenient (they will be used in this chapter for the same reason), but their convenience must not be allowed to obscure the fact that the physical property is not the true subject of the appraisal. It is the value of *legal interests in real estate* that is estimated. The words "legal interests" mean "legal rights of ownership", and the true subject of an appraisal is the particular rights of ownership vested in a certain piece of real estate. Investigation of these ownership rights is as important as an examination of the physical property.

legal interests in real estate
the legal rights of ownership vested in a particular piece of real estate

The most common interest in land to be appraised is the fee simple interest, but there are other lesser interests and there may also be charges registered against these interests such as existing leases, easements, mortgages, and liens. The legal interest in real property may include:

- Fee simple ownership
- Leasehold estate (long-term, pre-paid leases)
- Condominium ownership (a combination of fee simple ownership of a unit and ownership as tenants in common of the common areas)
- Air space rights
- Easements (e.g., for hydro right-of-ways)
- Any combination of these separate interests

ALERT

It is crucial to ensure the appraiser has properly considered the property's title status. Consider whether the land is owned in fee simple, a long-term ground lease, a cooperative, or a strata-titled property? Are there any easements or restrictive covenants affecting the marketability of the property? Are there any liens or tax claims that impact the security of the mortgage lender?

Examples

1. Two properties are identical in all respects except one is leased, with the tenant responsible for all operating expenses, while the other provides that the landlord be responsible for all operating expenses.
2. Two residences are identical in all respects except one is subject to an existing mortgage that provides for interest at 3% per annum when current interest rates are 5% per annum.
3. Two similar condominium units are offered for sale. One is located in a project with extensive common areas and a large contingency reserve fund, while the other is in a project with almost no common area and the minimum reserve fund permitted under law.
4. Two adjacent retail spaces are physically the same in all respects. The fee simple owner of Store A has rented the property to a tenant for $4,500 per month, while the owner of Store B has rented his store on the same lease terms for $4,350 per month. If the leases run for the same number of years, the value of the first owner's interest must be worth more since he receives an extra $150 per month during the remaining lease term.

In each of these examples, the properties are similar physically but the ownership rights differ. Different ownership rights will affect the value of property. When the valuator examines these properties, they must consider the effect the differences in ownership rights have on the property.

The importance of ownership rights in the appraisal problem has been stressed because overlooking this fundamental point can lead to major valuation errors. The nature of the interest in land will largely determine the type of data required to complete the appraisal.

Appraisers must obtain clear instructions from the client to determine the interest to be appraised. The client will sometimes ask for a value that is different from one that is found on title. For example, the client may wish to know the market value of the fee simple interest as if it were unencumbered when, in fact, there is a mortgage registered against the property that cannot be released. By assuming a clear title held in fee simple, the appraiser could be ignoring vital information affecting the value of the real property.

ALERT

An appraiser may be asked to appraise the value of a fee simple property that has an unusually expensive (high interest rate) mortgage attached. If the mortgage cannot be prepaid, it will affect the value of the fee simple interest. Therefore, to assume the mortgage does not exist oversimplifies the appraisal problem and will not provide a true estimate of value.

Disclaimers, Assumptions, and Conditions

Appraisers typically include a variety of disclaimers in their appraisal reports, usually in the form of limiting conditions and assumptions that are inherent in the estimate of value. These disclaimers can potentially excuse what liability may be owed by the appraiser and to whom. Appraisers will normally specify that liability is owed only to the client and not to any other readers or users of the report.

The limiting conditions and assumptions in a report can limit the appraiser's liability for specific issues, such as engineering or environmental issues that may impact the property and its value. However, disclaimers cannot be used to waive away the liability for gross negligence on the part of the appraiser in delivering the service. It is implied that an appraiser will do a proper job and that they are being hired for their expertise – an appraiser cannot use a disclaimer to excuse themselves from applying their expertise.

Appraisers can use disclaimers to limit the scope of their liability. They cannot waive their professional obligations to their client, or be negligent in providing their service.

For example, although an appraiser is not a structural engineer, obvious signs of serious foundation issues (e.g., massive cracks in the foundation) must be noted and accounted for. The appraiser can include a limiting condition that their professional qualifications do not include those of a professional engineer and also an assumption that the foundation is structurally sound; however, the appraiser must report on obvious evidence of the building's condition that would likely impact its value. If apparent significant problems were not reported, the appraiser might be held liable for negligence in not fulfilling their professional obligations, not meeting the standard of care expected for appraisers in this role.

Legal responsibilities of appraisers and for licensees completing valuation work are described in more detail later in this chapter.

As a Mortgage Broker...

The sample residential appraisal report form posted on the course resource webpage includes a page of assumptions and limiting conditions. These specify what the appraiser did and did not do as part of the appraisal assignment, and potentially limit their exposure to liability.

Licensees tend to report their valuation analysis in a much less formal way, often with a short comparative market analysis (CMA) report, which is unlikely to include these disclaimers. As such, licensees must be cautious to ensure that the client has no misconceptions about the degree of inspection and research undertaken. Where there are unusual circumstances, such as not being able to access the property for inspection or the client requesting that certain property attributes be ignored, these should be noted clearly on the CMA report, to ensure that no reader may be misled as to the basis for your value conclusion.

STEP 2: SCOPE OF WORK DETERMINATION

The *scope of work* refers to the amount and type of information researched and the analysis applied in the valuation assignment. Scope includes, but is not limited to, the extent of:

- Identification and inspection of the subject property

- Research into physical and economic factors that could affect the property
- Data research, verification and inspection of comparables
- The type and extent of analysis applied

scope of work
the amount and type of information researched and the analysis applied in the valuation assignment

The scope of work applied must be sufficient to result in opinions and conclusions that are credible in the context of the intended use of the appraisal. The appraiser has the burden of proof to support the scope of work decision and the level of information included in a report.

Scope of work may be reflected in the outcome of the report, because the degree of due diligence demanded by the client may impact the value conclusions. For example, a “drive-by” appraisal commissioned for $100 may not uncover the same value influences as a $5,000 narrative report commissioned as support for an expropriation proceeding. Both of these conclusions may be justified though, as long as they are within the client’s requested scope of work and any limitations are specifically noted in the report.

Scope of work is linked directly to the legal responsibilities and standard of care concepts expected for professional work (discussed in more detail later in this chapter). The scope of work defines both the degree of due diligence needed to develop a credible value conclusion and the appropriate means to report this. For example, a licensee completing a comparative market analysis (CMA) for a listing presentation would be unlikely to complete the same level of analysis or reporting as an appraiser completing an expropriation analysis. This CMA would not likely meet even the relatively less in-depth analysis required for an appraisal for mortgage financing purposes. However, the CMA still requires some degree of market research and analysis, and the conclusion would likely be expressed in some form of short written report. CMAs are explained in more detail later in this chapter.

FIGURE 15.2: Appraisal Report Excerpt: Scope of Work Statement

Inspection: We inspected the interior and exterior of the property on (date), accompanied by (Name). Our identification of the property also involved a review of mapping prepared by the local municipality, and our earlier files on the property. The photographs appended were taken (date).

Type of Analysis (The following example relates to an update assignment): The approaches as applied to our previous report of (insert date) were investigated as to their relevance to this assignment, including a review of market data necessary to properly apply these approaches. In this regard the (direct comparison, income and/or cost approaches - as appropriate) have been applied and later reconciled to a final estimate of value.

Data Research: We received our instructions from (name), who provided information on the property and on changes to it since our (date) appraisal. Publications produced by the (local authority) provided information on applicable land use controls. Sources of market evidence included, as appropriate, the local real estate board, Land Title Office transactions B including those reported by Data Systems and local assessors, and real estate agents, vendors, and purchasers active in the market. The (name) service provided information on the state of title.

Audits and Technical Investigations: We did not complete technical investigations such as:

- Detailed inspections or engineering review of the structure, roof or mechanical systems
- An environmental review of the property
- A site or building survey
- Investigations into the bearing qualities of the soils
- Audits of financial and legal arrangements reported by (name) concerning the leases

Verification of Third Party Information: The analysis set out in this report relied on written and verbal information obtained from a variety of sources we considered reliable. Unless otherwise stated herein, we did not verify client supplied information, which we believed to be correct. The mandate for the appraisal did not require a report prepared to the standard appropriate for court purposes or for arbitration, so we did not fully document or confirm by reference to primary sources all information herein.

Figure 15.2 provides an example of a scope of work statement presented in an appraisal report. The appraiser's intention is to clarify to the reader what research and analysis was completed in support of the value conclusion. By stating this clearly, the appraiser leaves no room for doubt as to what was done and what was not done in preparing this report.

STEP 3: DATA COLLECTION

Once the appraisal problem has been defined and the scope of work established, the next steps involve identifying and gathering the information needed to appraise the subject's value.

Data collection and property description involves collecting and analyzing data on the subject property and comparable properties. There are two types of data to be collected when carrying out appraisals:

- General data is information on the country, province, municipality, and neighbourhood categorized under social, economic, political, and physical factors
- Specific data that relates to the property and its rights

The market environment, in which the subject property would trade if it were listed, is affected by national and international factors of supply and demand. Their influence on property value may be direct or indirect and their effects are often (although not always) felt in the long run. Regional and neighbourhood factors will have more effect on the values of property in the short run.

An appraisal report should contain a section on the background analysis that analyzes developments and trends in social, government, legal, political, and economic matters at the appropriate geographic levels.

The objectives of the background analysis are to:

- Provide the user of the report with an understanding of the social and economic climate within which the market forces of supply and demand are operating
- Indicate the current status of the subject property relative to the market trends
- Establish that the comparative sales data used in the appraisal report have been selected from a market where the conditions are similar to those surrounding the subject property

At each level, the facts, trends, and developments important to the particular appraisal report, and the effect these factors will have on the value of the subject property, need to be determined.

General Economic Factors

The general economy establishes a framework within which the different real estate markets operate. General economic factors cannot be controlled by the decisions of individual buyers and sellers; they include such things as:

- Inflation
- Unemployment
- Interest rates
- Exchange rates
- Government policies
- Political stability

These factors create an overall economic climate and influence the intermediate to long-term expectations of market participants. Not every region will be affected uniformly by these market forces; some communities will expand and prosper while others may face a recession. These general economic forces tend to change more slowly and are less important to the appraiser than the factors affecting supply and demand within a particular real estate market. Appraisals are usually prepared based on a very short time horizon (e.g., a few weeks) and the market sales evidence is very recent. Therefore, most general economic factors can be ignored since they will remain the same over a period of a few weeks. Expected government policy announcements are one factor the appraiser may want to consider in the appraisal report.

The long-term analysis should consider the basic economic health of the nation and the likely major changes that will influence real estate markets. The concerns are the social and institutional stability, relations with foreign countries, availability and cost of resources, and shifts in national priorities. The ultimate purpose of these considerations is to describe the position of real estate investments in comparison with other investments. The appraisal report should state some general conclusions with regard to economic factors.

The time and effort devoted to these factors will vary with the function of the appraisal and the conditions in the market. If ample recent market data supports the estimate of value, less emphasis will be given to the international or national trends. In contrast, if the available market data is not recent or the value of the subject property is relatively high and the property appeals to national or international investors, greater emphasis will be given to these general economic factors.

Property buyers and sellers consider not only the property in its present state, but also in terms of what can be derived from it in the future. While past trends cannot guarantee the future, they can provide clues as to what might be expected. A *trend* is defined as a series of related changes brought about by a chain of cause and effect. These changes are studied in order to measure a historical trend, which then forms the basis for forecasting a future trend. Trends that influence property valuation include building cycles, regional or local economic cycles, population growth and decline, interest rate fluctuations, average house prices, and urban renewal. Most lenders, buyers, and sellers are concerned about trends that affect values from the immediate past to the immediate future; longer term trends are generally less influential.

trend
a series of related changes brought about by a chain of cause and effect

FIGURE 15.3: Examples of International and National Economic Factors

Long Term Trends

- Balance of payments between Canada and other countries
- Shifts in the balance of trade between countries
- Supply and cost of raw materials and energy
- Shifts in governmental institutions and regulations
- Expected changes in tax laws
- Government programmes affecting real estate
- Population shifts

Short Term Trends

- Bank of Canada monetary policy
- Governmental demands for funds
- Private demand for funds
- Expectations for gross national product and its components
- Consumer pessimism or optimism
- Interest rates on:
  - treasury bills
  - prime business loans
  - corporate bonds
  - residential mortgages
  - commercial property mortgages

Regional Analysis

If a region undergoes changes relative to other regions, local real estate values may change. Regional analysis may be particularly important in Canada where regional differences in employment, economic base, and income levels are significant.

An analysis of regional considerations usually deals with natural resources, population migration, climate, topography, location of markets, income levels and trends, transportation systems, and tax levels. When the analysis concentrates on a province, additional matters to consider may include provincial laws affecting real estate organizations and migration patterns between provinces.

The framework for the economic analysis of a region is usually a study of the major local economic activities. Many regions or communities have conducted such a study, which can serve as the starting point for the appraiser's analysis. Alternatively, the information may be available from Statistics Canada (*www.statcan.gc.ca*). The census data describes the types of employment in an area, often as a percentage of that area's total employment. This information may not be available for smaller areas; however, the community likely has conducted a study in this case.

The real value of an economic base study to an appraiser lies in a description of the level and changes of the region's sources of employment and income.

Government, political, and fiscal factors are probably most noticeable at this level. Responsiveness of city and regional governments to community needs, tax rates, services, the quality and efficiency of local governments, government agencies, zoning, and building and housing codes can all influence the general level of real estate values in a region. Revenues from utility operations or other tax sources allow a community's real property tax to remain lower than it would be otherwise; if no such alternative sources exist, real property tax rates will rise to provide revenue for local governments.

The social structure of a region is described in terms of population characteristics, age structure, types of employment, income levels, and racial, ethnic, and religious characteristics. Social homogeneity is usually found in smaller communities that are highly dependent upon a single industry or employment source. Larger cities that have diverse employment sources are socially quite different.

The social characteristics of a community often reflect its economic base. A community with a high percentage of employment in heavy industry tends to have many middle-class residents and some high-income residents who are officers or stockholders in the industry. These communities often feel the cyclical effects of economic activity to a greater extent than cities more oriented to white-collar service industries. Cities containing major offices for provincial governments or major universities tend to be more stable, but their income levels are usually not as high.

Neighbourhood Analysis

A *neighbourhood* is defined as a *geographic area of relatively similar residences and physical surroundings*. The valuator must research and analyze the neighbourhood that contains the subject property and the other properties used to support the estimate of market value.

neighbourhood
a geographic area of relatively similar residences and physical surroundings

The characteristics of a neighbourhood usually have the greatest impact on the subject property since the neighbourhood constitutes a property's immediate environment. The value of the subject property is highly related to trends and developments in the neighbourhood. The neighbourhood sets the price range and rarely will a property fall outside this range. Although not a recommended practice, experienced appraisers and or licensees can usually give reasonably accurate estimates of the value of properties simply because they know the price ranges in the various neighbourhoods in the city.

The neighbourhood boundaries should be shown on a map in the appraisal report. The area should be *relatively homogeneous* with respect to a number of variables, such as the social background and income levels of the residents and the quality, price range, age, and size of the structures. It is the appraiser's job to decide whether the neighbourhood of the subject property should contain a larger or smaller area. In defining a neighbourhood, the key characteristic is the degree of homogeneity of an area relative to other possible areas of larger and smaller size. If a certain area contains a significantly greater degree of homogeneity than would a larger area, and if the degree of homogeneity would not increase significantly by decreasing this area, the neighbourhood has been defined. Although there is no standard minimum or maximum size of neighbourhood, the appraiser should be cautious whenever the analysis shows the neighbourhood to be an unusually large area.

Most neighbourhoods have rather distinct boundaries that include the following:

- Natural barriers, such as hills, streams, lakes, and swamps
- Man-made barriers, such as railroad tracks, streets, highways, and utility rights-of-way
- Legal boundaries, such as subdivision lines, zone boundaries, school district boundaries, city limits, and provincial lines

A neighbourhood is not necessarily comprised of a single subdivision. Subdivisions have legal boundaries but these boundaries do not always define the neighbourhood. There may not be complete similarity within the same subdivision. Differences within a subdivision may require that the appraiser exclude parts of the subdivision and include parts of other subdivisions to define the neighbourhood.

Example: Subdivisions

One subdivision contains a combination of moderately-priced houses and higher-priced houses. The higher-priced houses are located adjacent to another subdivision composed of higher-priced houses. In this situation, portions of two different subdivisions would form the neighbourhood of the higher-priced houses.

The street pattern, similarity of structural design, general property maintenance and appearance, the drainage in the area, and the amount of open space are additional important considerations in judging relative homogeneity. It is the appraiser's job to judge the *value-enhancing* and *value-detracting* aspects of the neighbourhood's physical characteristics, based on the standards set by the participants in that market. The neighbourhood section should contain a description and analysis of the physical features that add to or detract from values within the neighbourhood in which the subject property is located and from which the sale data are selected.

Wealth and income levels of the neighbourhood's residents, together with price and value trends, comprise the local economic characteristics. Average wealth levels for census tracts may be obtained from census reports. Income level data can be obtained from a variety of sources. While the neighbourhood will not usually conform to the area for which income data are available, the information will provide a general idea of the income level of the neighbourhood. The appraiser could also attempt to determine sources of the employment for area residents to infer general income levels.

Stability of incomes should be considered; government and institutional employment is more stable in terms of income levels than business and industrial employment. However, business and industrial employment usually provides higher pay levels for jobs of comparable responsibility. Self-employed professionals, such as physicians, lawyers, dentists, architects, accountants, and engineers, typically fall between the two groups.

The questions to be answered in wealth and income analysis include the following:

- Are the residents able to afford their properties on a continuing basis?
- Is the rate of turnover of properties expected to change because residents' wealth and incomes are either insufficient or too unstable to allow continued occupancy?

The residents' economic characteristics will also be helpful in determining the probable characteristics of potential buyers for the property (i.e., the demand side of the market).

The *social characteristics* of a neighbourhood's residents are generally related to economic characteristics. The general levels of wealth and income of the neighbourhood are key determinants of social class. Other important social characteristics are the educational levels, occupations, and age of the residents.

The appraiser should consider whether the community's zoning, building, housing, fire, electrical, and plumbing codes are adequate for the neighbourhood. For example, are there loopholes in the zoning code that would allow uses to be introduced that would detract from the neighbourhood? Or, are there deficiencies in the fire, electrical, or plumbing codes that are likely to cause serious difficulties in the structures within the neighbourhood?

The manner in which the codes are administered and applied to the neighbourhood is as important as the contents of the codes themselves. Are they administered consistently and fairly? How difficult is it to get codes changed or to obtain a variance? Do they cover the type of development existing in the neighbourhood?

Services provided to the neighbourhood are important aspects of the local government. Fire and police protection, garbage removal, schools, and recreation facilities should be considered in this category. Are they adequate to enhance and preserve values? Are they consistent with the level of real property taxes?

Finally, the level of real property taxes needs to be compared to similar neighbourhoods. Occasionally, a neighbourhood's residents may even promote high property tax rates to limit house purchasers to those in upper income brackets. What is the chance that the relative tax burden will shift? To what extent will property values be affected? The appraiser should answer these questions in addition to questions concerning the services provided relative to the tax burden imposed.

The *accessibility* of a neighbourhood depends on the proximity of supporting facilities. How close are places of employment, shopping centres, schools, churches, and recreation facilities? Convenience and ease of access add to the attractiveness of a neighbourhood and, as a result, increase property values. A new transportation improvement such as a freeway, bridge, or a new mass transit route may affect the accessibility and the values in a neighbourhood.

accessibility
the level ease with which customers can reach the property

Neighbourhoods are constantly changing but they do not all change in the same way at the same time. Distribution of the change in an area will depend largely on historical trends, transportation routes, the location of the employment, and local government policy decisions. For these reasons, a simple "snap shot" of a neighbourhood at a certain time is not sufficient; the appraiser must look at the way in which the area has developed to its current position and must identify probable future trends.

Questions to ask while collecting neighbourhood data and analyzing the market include the following:

- What factors, considered important to buyers and sellers, exert the greatest influence on the type of property being appraised?

- How should the market for the subject property be identified?
- What market conditions, considered important by buyers and sellers, have changed between the date of the appraisal and the date at which comparable transactions occurred?

Neighbourhood Analysis by Property Type

In a residential neighbourhood analysis, key factors include the following:

- Distance and access to public transportation
- Distance and access to amenities and recreational facilities (e.g., parks and playgrounds)
- Long- and short-term vacancy rates

In a commercial neighbourhood analysis, key factors include the following:

- Population, incomes, and demand of the trading area
- Major traffic thoroughfares
- Parking facilities
- Competition from other areas
- Compatibility of uses
- Direction of growth
- Vacancies

In an industrial neighbourhood analysis, key factors include the following:

- Labour pool
- Services
- Materials

In a farm neighbourhood analysis, key factors include the following:

- Types of soils and crops grown
- Livestock facilities
- Services
- Distance to markets
- Community life

Subject and Comparable Property Data

An appraisal normally requires thoroughly inspecting the property inside and outside. An obvious exception is the case where the existing improvements are to be demolished within a short period of time. The property inspection should not present any great difficulties if one knows what to look for, takes a logical approach, and conducts the inspection from the point of view of a potential buyer or seller.

The site analysis should consider the following factors:

- **Physical factors:** site dimensions (i.e., frontage, depth, width, shape, area); soils (e.g., sandy, clay, rock, or silt); plottage, excess land, and assemblage; topography (i.e., elevation and contour); climatic conditions; services and utilities; roads and street patterns; landscaping
- **Location factors:** land use patterns; access; ease and convenience of amenities (e.g., shopping, schools, places of employment, recreation); hazards and nuisances
- **Legal – governmental factors:** lawful and restrictive uses of the site; title information; zoning; taxes and assessment; easements; leases; restrictive covenants
- **Economic factors:** prices of comparable sites; tax burden and method of payment; utility costs; service costs
- **Environmental factors:** environmental problems or toxic contamination; costs of clean up

Improvements to the site should also be inspected. Structures are buildings that are erected on the land for a specific purpose (e.g., single-family dwellings, multiple dwellings, commercial use, industrial use, agricultural use, special purpose such as schools, hospitals, and banks). Site improvements are usually done to the site, rather than on the site.

The appraiser should observe the property through the eyes of the market place, ignore personal preferences, and keep in mind that unusual conditions may be irrelevant to buyers and sellers. For example, where unique materials have been used in construction, and unless market participants consider these materials to contribute extra value, the appraiser should not make adjustments for these materials in determining market value.

In all cases, property inspection records should be kept for reference at a later date. Although there is no standard set of inspection forms or checklists, it should be noted that the more detailed the property inspection checklist is, the better the inspection report that will result.

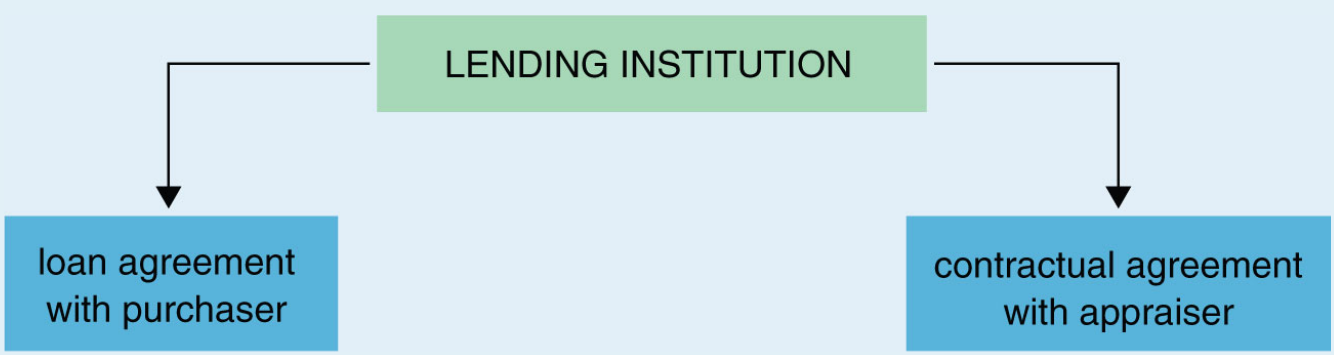
Measurements should be carefully recorded; each floor should be completely inspected before moving to another floor. Items that are important to the participants in the market should be noted; for example, in the case of a single-detached house, these items include the number and arrangement of rooms, logical traffic flow, number of heating outlets and number of electrical outlets.

Important information might not be readily available on inspection. For example, the appraiser may wish to know if the house is insulated and if the water piping is copper, and inspection of these items would damage the interior finish. In this case, the owner may know the answer. The source of the information must be noted in the report; it should also be recorded that this information has not been confirmed by the appraiser.

All of the site and neighbourhood's physical aspects that have a significant bearing upon property values, whether natural or human-made, should be identified and analyzed. Soil conditions should not be overlooked in cases where they may influence the type of structure that can be constructed. The area's terrain and topography should be noted and any unusual features that might influence value discussed. Wooded and hilly lots, which are some of the most aesthetically desirable settings for houses, often require additional hauling, filling, and grading.

Example

Appraisers are legally responsible for their physical inspection of the subject property (*Cantwell v. Petersen*, 1982 CanLII 292 (BCSC)). Here, the British Columbia Supreme Court dealt with a case involving a negligently prepared appraisal. The purchasers of a property required mortgage financing. The lender insisted that the property be appraised and hired an appraiser to do the job. The purchasers subsequently examined the appraisal, although they had no legal right to do so because they were not parties to the contract, between the lender and the appraiser.



Later when the purchasers discovered the house was infested with insects and ridden with dry rot, they sued the appraiser for his failure to detect these defects and include them in the appraisal report. The Court had little trouble in concluding that the appraiser had been negligent in preparing the report. The court also found that while there was no contractual relationship between the purchasers and the appraiser, the appraiser should have known that the purchasers *might* see the appraisal and rely on it. Accordingly, the appraiser owed a duty to the purchasers and, in preparing a negligent appraisal he breached that duty. The appraiser was found liable to the purchasers for the difference between the purchase price and the reduced value of the home due to the dry rot and infestation.

Damages $	=	Sales Price of Home	Less	Actual Value of Home

Transactional Elements

In working with property sales, appraisers must watch for elements in a transaction that may have influenced the sale price. Potential transactional influences might include the following:

- Time allowed for the sale
- Amount of advertising
- Relationship between the parties to the sale
- Terms of financing involved
- Special purchasers

Time

Real estate is a commodity that cannot be sold quickly. The length of time allowed for the sale to take place will affect the eventual sale price realized. For example, if a property must be sold within a week, the price obtained will likely be lower than if the seller had a two-month timeline. Similarly, the buyer who must buy within 10 days can expect to pay more than someone who is not acting under this time constraint.

The relationship between time and the sale price of a property is not necessarily linear. Assume that a property priced close to market value will sell at market value after having been listed for the average number of days, given its particular market. Note that the average days on market figure can vary significantly from market to market. A property priced below market value will likely sell faster than average, as prospective buyers seek to beat others in the purchase of the undervalued property. However, a property priced above market value will not simply take longer to sell; if the property is priced too high, it is not likely to sell at all unless market conditions shift or unless the price is reduced in line with the actual market value of the property.

Licensees might come across sellers wanting to price their property well above its market value, based on the logic that they are not in a rush to sell. A licensee should explain that overpriced properties are unlikely to sell regardless of the amount of time a property is listed for sale, unless market conditions change. Further, licensees should discuss how overpricing a property can hinder the sale of the property in other ways. For example, as a property grows "stale" (sits on the market without any purchase activity), momentum from potential buyers will fade. Buyers may stigmatize the property, assuming that if nobody else has been willing to purchase the property, then there must be something wrong with it.

Advertising

If a property is sold without advertising, its sale price will normally be lower than if it is adequately advertised. This occurs because fewer potential buyers are aware the property is on the market.

Sales Between Related Parties

In an open market transaction where the buyer and seller both seek to make the best bargain for themselves, they are not inclined to make any voluntary concessions to the other party. One party is trying to buy for as little as possible and the other is trying to sell for as much as possible. However, in some cases there may be some relationship between the buyer and seller that results in voluntary concessions being made; for example, an elderly man who sells his home to his child when he moves into a long-term care facility.

A relationship may also exist where one party exerts undue influence over the other. For example, consider the case of an unscrupulous accountant who convinces his client that, in order to keep his business viable, the client must sell his home. The accountant then buys the home for a price that is lower than the price that would be received in an open market transaction. The influence of the accountant over his client has resulted in a sale price that would not occur under normal circumstances.

Financing

The terms of the financing involved in any particular sale may also affect the sale price. For example, if a house is sold with the vendor taking back a mortgage with a low interest rate to cover part of the price, the sale price of the property should be higher than the sale price if the buyer had paid the full amount in cash. The same principle holds true where a purchaser assumes a low-interest mortgage – a portion of the sale price paid by the purchaser may actually be attributed to the financing benefit rather than the real estate. In this case, the sale price must be adjusted downward in order to isolate the real estate's value alone. Such an adjustment would be based on the present value analysis techniques illustrated in Chapter 11.

Special Purchasers

Buyers and sellers are influenced by available substitute properties. However, a special purchaser may have a ceiling price that is much higher than that of other potential buyers. Their presence in a transaction will greatly extend the range of possible bids. A most common example of a special purchaser is an owner of a retail or industrial property who wants to expand their business by purchasing the property next door. The adjacent property has a unique advantage to them that no other location can offer because it allows them to expand without relocating. By purchasing the adjoining property, the special purchaser would save moving and other relocation costs; these potential savings allow them to offer more than any other potential buyer.

Special purchasers are not very common. Transactions involving special purchasers raise the question as to whether the price paid by such a buyer falls within the definition of market value. There is no definite answer; if the circumstances are such that the price can be *reasonably expected*, it represents market value. However, if the presence of a special purchaser cannot be reasonably expected, the transaction must be considered as an unusual sale and it should not be used as an example of market value. The price paid by a special purchaser is seldom, if ever, useful evidence of the value of other similar properties.

ALERT

Licensees should be on the lookout for two types of "special purchasers":

- **Mortgage fraud:** where the false purchasers buy the property for more than it is worth, artificially raising its apparent value, and then pursue mortgage financing based on this inflated value. If the value seems too high, too good to be true, then look into it. Compare it against assessment value. Investigate the comparables, are they actually similar? Do they indicate an appropriate value range?
- **Speculative Value:** a market in transition may see investors and potential developers buying properties for more than the value in the current use, speculating that a changing market and changing zoning will increase value. In appraising the market value of a property in these circumstances, the appraiser will have to make a decision regarding these speculative purchases: is it a special purchaser and to be ignored? Or is it a market trend that must be considered? Appraisal for financing tends to be conservative, ignoring speculative value – e.g., the lender may specify a requirement to value the property based on a 30-day exposure time in the current use, ignoring redevelopment potential.

As a Mortgage Broker...

An appraiser may make adjustments to account for the transactional influences described in this section. However, it is very challenging to substantiate and support such adjustments with market evidence. This inevitably means applying subjective opinion in accounting for issues like non-arm's-length parties or a distress sale. With these difficulties in mind, appraisers in practice will tend to limit their reliance on such sales or, if there is sufficient alternative market evidence, to omit them entirely as unreliable. This can potentially lead to problems, for example if a seemingly "perfect" comparable is omitted without explanation – best practice in this situation is to explain in the report why the sale has not been considered and any impact this omission may have on the value conclusion.

STEP 4: DATA ANALYSIS

In this step, the appraiser must understand how these elements of demand and supply affect the value of real property in order to make predictions of prices, given certain market conditions.

The appraiser needs to keep abreast of the local, national, and international markets and their impact on property value. This may be through the various business and real estate publications relevant to the field in which they specialize, be it residential, commercial or those specialized areas such as expropriation.

As a Mortgage Broker...

Appraisal reports often detail the market analysis as described in this section. A licensee's abbreviated valuation report, such as a CMA probably will not provide this level of explanation. However, the licensee must also be well versed in all of these areas. To provide accurate valuation advice, the licensee must have a thorough understanding of the local market and be able to communicate this knowledge to buyers and sellers.

Demand for Real Property

Demand measures the quantity of property that the market would like to purchase at any given price. A basic economic hypothesis is that the demand for real property will decrease as price increases. The quantity demanded for any particular property is influenced by the following:

- Changes in population
- Changes in income
- Changes in the preferences and tastes of consumers
- Cost of alternatives
- Technological changes
- Changes in transportation facilities
- Government policies

Some factors affecting demand are local while others apply to a larger region. Changes in the transportation facilities of Vancouver will not affect real estate markets in Toronto but a government policy that allows homeowners to deduct interest paid on a mortgage from their taxable income will change the demand for real property across the country. In some cases the factors affecting demand will change gradually (e.g., the age composition of the population), while in other cases the change may be abrupt (e.g., announcement of new zoning bylaws).

Supply of Real Property

Supply measures the quantity of property that will be supplied at any given price. In contrast to demand, the supply of real property increases as price increases; that is, owners of real property become more willing to sell their holdings as the price increases. The factors affecting supply include such things as the price of the property, the price of alternative properties, technology, and the goals of the owner.

Because land cannot be created or "manufactured", most people believe the supply of land is fixed. However, this is only partially true in terms of its impact on real estate markets. The absolute supply of land on the surface of the earth may be fixed, but the supply of real property (land and improvements) can be altered by changing the use of a parcel of real property. If the supply of apartment buildings must be increased, houses may be torn down and replaced with apartment buildings. If the supply of houses must be increased, farmland may be turned into subdivisions.

Two important characteristics of the supply of real property have a significant impact on the value of real property:

1. The supply of real property cannot be increased or decreased rapidly.
2. The supply of real property is fixed in location.

Urban land developers cannot respond quickly to a change in the demand for a particular type of real property. It takes time to determine the type of property in demand, acquire land, arrange financing, build the improvements, and sell the interest. In contrast, some businesses can respond very quickly to changes in demand. The fact that the supply of real property cannot be changed rapidly means that the current prices of properties are determined mainly by the demand for property. This does not imply that the supply of real property never changes, just that these changes take place slowly.

Real property markets are, by nature, local because of the immobility of real property. This implies that real property will be affected by external influences from neighbouring properties (externalities). Immobility also implies there will be differences in the type of real property supplied between areas but little difference in the type of property supplied within an area. For instance, an area composed mainly of office buildings will not contain many single-family residences; however, a neighbouring area may be made up entirely of single-family residences. There will be differences in the supply of real property from one area to another as well as changes in supply over time.

In conclusion, the price at which a property will sell is strongly influenced by the prevailing market conditions. These include all factors that have an impact on the decisions of buyers and sellers and, in turn, an impact on demand and supply. The factors that determine the demand and supply of real property will vary with location and over time. If supply and demand differ between locations and over time, the price paid for similar properties will also differ between locations and over time. In valuing a piece of property, the appraiser must be aware of the factors exerting a strong influence on demand and supply at that particular location and at that particular time. Appraisers must also be able to predict how buyers and sellers will be influenced by market conditions in determining the sale price of a specific property. This prediction will be based on the perception of the past behaviour of the market participants and knowledge of market conditions.

Real Estate Market

The appraiser must be familiar with the general nature of real property markets, their operation, and organization. The real estate market consists of several smaller markets, although it is common (and misleading) practice to refer to "the real estate market" as if it were one market. Several different markets may be contained within the same geographical area; these smaller markets can usually be divided even further. Any given geographical region may be classified into markets according to the following:

- **Land use types:** residential, commercial, industrial
- **Location:** inner core, suburbs
- **Price ranges:** low, average, expensive

The boundaries of these smaller markets may be overlapping or, an appraiser may first classify an area by its land use type and then further classify these areas by price range.

Being able to identify and classify the market in which the subject property is located is important; its impact will depend on the nature of the property itself.

Example: Real Estate Markets

- The market important to a single-family residence is usually the surrounding neighbourhood. In estimating market value, the appraiser will try to gather evidence from this neighbourhood.
- The market that is important to a strip mall containing a 24-hour grocery, laundromat with a dry-cleaning service, bakery, and video rental store will be larger than the immediate neighbourhood. It

may include an area extending to 1 or 2 miles depending on the location of competing services.

- The market that is important to a regional shopping centre will be much larger than the immediate neighbourhood. It will certainly include the relevant town and may include neighbouring towns. The appraiser will have to collect data from nearby regional shopping centres which may involve an area extending to several different regions.

In an economic sense, the real estate market is an imperfect market. The nature of real property makes it more difficult to predict how demand and supply will affect price. The imperfections are due to:

- a small number of buyers and sellers relative to the total number of properties;
- the uniqueness of each parcel of real property;
- the lack of information readily available to buyers and sellers; and/or
- the fact that not all buyers and sellers strive for the most profitable bargain.

These imperfections are more prevalent in some types of real estate markets than others. Given less available information, establishing market value for an unusual structure is likely more difficult than for a single-family residence in a subdivision with more available information. Generally, the less perfect the market, the more difficult it is to establish market value.

Degree of Development: Highest and Best Use Analysis

Before deciding on the most suitable appraisal approach(es), the nature of the development of the subject property must be examined since this will help to eliminate some potential appraisal methods.

In appraisal, properties are analyzed by their degree of development: those representing highest and best use and those possessing potential for redevelopment (or latent value).

Highest and best use is a fundamental concept underlying real estate appraisal. When appraising a property, the appraiser must consider whether the current use reflects the most profitable, legal use of the land; if not, they must consider the value of the potential alternative uses such that the land meets its economic potential. As a rough indication of whether an existing property represents it highest and best use, it is useful to ask, “If this building burned down, would the same type of building be constructed in its place?” If the answer is “yes”, the existing development probably represents the highest and best use.

highest and best use
that use of land which, within all legal, physical, financial and market constraints, will provide the maximum net return during the foreseeable future

Highest and best use implies that the existing development is likely to yield the maximum net return to the land during the foreseeable future. The term “foreseeable future” refers to the time period a typical participant in the property market would use as a planning horizon. “Net return” refers to the total property income after all operating expenses are subtracted and is usually expressed in terms of money. However, for some types of properties such as owner-occupied houses, the net return is expressed in non-monetary benefits.

Generally, highest and best use focuses on the property owner specifically, rather than the wishes of the public-at-large. Appraisers will typically consider public opinions as represented by elected local governments, specifically demonstrated in Official Community Plans (OCPs) and zoning bylaws.

If the present use is the highest and best use of the existing land and improvements, then compiling the information may be quite straightforward. If it is not, then a separate highest and best use study will have to be carried out before any market data can be collected for analysis purposes. Both the land and improvements will have to be examined separately to establish their highest and best use. The three traditional appraisal approaches all require that a property be in its highest and best use – so it is critical for appraisers to determine if a property’s present use is the highest and best use before beginning the valuation analysis.

Latent value, or potential for redevelopment, exists when the maximum net returns are likely to result if existing development is changed at some time in the foreseeable future. In other words, when a property possesses latent value, the current use of the development does not represent the highest and best use.

latent value
the value possessed by a property that has potential for redevelopment because it is currently not employed at its highest and best use

Example: Latent Value

An old farm house is rented at $1,200 a month and located in a block where most of the original houses have been torn down and replaced by suburban retail space. The farm house is situated on land zoned for commercial uses. This is an example of a property that possesses latent value. The owner would receive the maximum net returns from this property if the house was torn down and a commercial building built on the site. In this case, it appears that the existing development will be changed in the near future to take advantage of the higher commercial value when redeveloped.

Before development, the property is said to have latent value or potential for redevelopment. When current returns from a property are extremely low in relation to the value if redeveloped, the property is described as being "ripe for development". Its highest and best use is when the property is developed to its more profitable use.

Real estate with potential for redevelopment is generally found on the boundaries between areas of different kinds of development. Examples include areas between:

- commercial and residential use;
- residential use and vacant acreage; or
- single-family homes and apartment buildings.

Most properties representing highest and best use are located within districts of similar use and development. For example, a single-family residence in the centre of a new subdivision represents the highest and best use for that property. In fringe areas, it is common to see a mixture of new buildings that represent the highest and best use of the site, and older buildings that have redevelopment potential.

The classification of property into either highest and best use or with redevelopment potential categories is complicated by zoning and restrictive covenants. These controls may prevent development or use that would yield the greatest returns to the land. The developer must determine whether a property has redevelopment potential if the proposed new use is prohibited by law. The answer depends on the chances of removing the restriction:

- If the control cannot be removed, the existing development is probably the highest and best use.

- If the control can be removed, latent value will exist and the redevelopment potential will be reflected in the higher price potential buyers would be willing to pay for the property.

There are no rules for dealing with the issue of zoning bylaws; and each case must be considered individually.

STEP 5: SELECTION OF THE APPROPRIATE APPRAISAL APPROACH

With the definition of the problem and the scope of work determined, the appraiser is able to identify which valuation approach is most appropriate for the subject property.

The three approaches to value are the:

1. Direct comparison approach, also called comparative approach or market approach
2. Income approach, also called investment approach
3. Cost approach

The three traditional approaches to value are interrelated; the nature and use of the property will determine which methods are most appropriate. If all three approaches are used, and the final estimate varies in each, then the final reconciliation will require evaluating the strengths and weaknesses of the approaches and a decision on which approach is most appropriate in arriving at the final estimate of value.

Direct Comparison Approach

The direct comparison approach (or comparative approach or market approach) is based on the *principle of substitution*: a property's value should be no more than the cost of purchasing a substitute property that provides similar utility. This approach assumes the market value of the subject property is equal to the prices recently paid for similar properties.

principle of substitution
approach to appraisal stating that a property's value should not exceed the cost of purchasing an alternate property that can provide similar utility

An in-depth understanding of the basis for real estate values and how these values are changing is necessary, with the source of this market knowledge available from historical sales data, listings, and offers to purchase. Listings help to see what is being offered for sale in a given price range. Offers to purchase may come from owners, purchasers, or licensees. A rejected offer to purchase often indicates the lower end of the selling range and may be of some assistance when actual sales data are difficult to locate.

Example: Varying Values with Appraisal Approaches

Assume an appraiser has valued a rental apartment building using the three approaches and estimated the following values:

By the direct comparison approach $1,000,000

By the cost approach $1,200,000

By the income approach $1,140,000

Using their expertise and understanding of the assumptions underlying each approach and the way in which the market views (and values) this type of property, the value indicated by the income approach may be considered to be the most realistic estimate of value. The appraiser must then explain why this $1,140,000 value conclusion is reasonable, hence the final estimate of value for the subject property at the date of appraisal.

Income Approach

The income approach (also called the investment approach) assumes that market participants consider a property's market value as equal to the present value of all its anticipated future net benefits. This approach is most often used for commercial real estate purchased as an income-producing investment.

Under the income approach, the sale prices and revenues (e.g., gross income, net income, or cash flows) for properties similar to the subject property are analyzed. The subject property's market value is then estimated using the results of this analysis.

The income approach relies on similar principles to the comparative approach in that it needs market evidence from similar properties – instead of directly comparing sale prices, the income method compares rental levels and operating expenses in relation to sale prices. Therefore, it can be argued that the income approach is simply a variation of the comparative approach.

Cost Approach

The cost approach assumes that the value of a property can never exceed the cost of replacing the property and that, under certain, limited circumstances, the depreciated cost of a property will be equal to market value. In general, the cost approach assumes that market value of a property is equal to the value of the vacant site plus the cost of constructing the improvements; and less depreciation if the subject building is not new.

FIGURE 15.4: Estimation of Market Value Using Cost Approach

	Value of the vacant land
+	Cost new of replacing current/existing improvements
=	Total value
−	Depreciation of current/existing improvements
=	Market value

The cost approach method appears to be the simplest, most precise approach to use. However, it is probably the least exact approach for finding market value in practice because:

1. the cost of building or producing an asset or attribute may not directly relate to how the market perceives its value; and
2. the difficulty in accurately measuring depreciation in older buildings.

It is sometimes difficult to decide which of the three appraisal methods is most appropriate, but limitations on market data often reduce the choice. For example, an appraiser who is asked to find the market value of a church would not be able to use the comparative or investment approaches due to the lack of data and might be forced to rely upon the cost approach.

Residual Method (Hybrid Technique)

When appraising properties that have redevelopment potential or latent value, the residual method is useful. It is a hybrid technique that relies on components of each of the three approaches previously introduced.

Under the residual method, the market value of the proposed new development (i.e., market value on completion) is first determined, either by the direct comparison or income approach. Second, the cost of pursuing the new development is deducted from the estimated market value on completion. These costs may include preparing the site for redevelopment (e.g., demolition costs and development permits) plus direct and indirect construction costs. Third, costs are deducted from revenues, and the remaining value or "residual" is the market value of the land in its highest and best use.

A variation of the residual method calculates the value of the building as the residual amount instead of the land. In this case, the land value may be known using the comparative approach and the value of the improvements is unknown. One difficulty is that it may not be possible to use the comparative approach to value the site if there is a lack of recent sales of sites with similar prospects for development potential.

Appraising Redevelopment Potential: Residual Method

Just because a property may consist of a house on a standard-sized lot does not mean that a single-family dwelling is its highest and best use. The property may have redevelopment potential and require special analysis by the appraiser.

Properties with redevelopment potential are appraised by the *residual method* (also called the developer's method or subdivision development method). Details of this method go beyond the scope of this course, but we will provide a simple example to illustrate its basic principles.

The residual method begins by finding the market value of a proposed new development (market value on completion) using another appraisal method such as the comparative method or investment method. The cost of creating the new development is then deducted from the estimated market value on completion, and the balance or residual, is the land value in its highest and best use.

Example: you are appraising a single-family house on a standard lot size in downtown Victoria. The house is surrounded by apartment buildings and is zoned for multi-family residential use. It cannot be compared to other house sales because it is more than just a house, it is effectively an "apartment building in disguise" (latent value). Its value must be determined based on its most profitable legal use.

Value of apartment building on this site	$10,000,000
Less: demolition cost	– $10,000
Less: cost to develop apartment building	– $5,990,000
Residual = Market Value of Land in highest and best use	$4,000,000

Discussion Point: Similar houses, but without redevelopment potential, are currently selling for $1,400,000. Assuming the basis for property tax assessment is market value, what is the property's current assessed value?

Answer: $4,000,000, as that is the maximally productive legal use of the land (highest and best use). The large tax bill for this residential property will encourage its redevelopment. Keep in mind there may be specific tax provisions or exemptions that lessen this tax burden, such as applying to have it assessed at use value (in BC, if the house has been occupied by the current owner for more than 10 years) or seniors may apply for deferment of taxes, payable upon sale.

STEP 6: RECONCILIATION OF VALUE INDICATIONS AND FINAL OPINION OF VALUE

The valuation analysis ends with concluding a final opinion of value. This requires evaluating the strengths and weaknesses of each of the value estimates from the various approaches, with a clear justification for the final conclusion. Usually, this is expressed as a single figure, but may be expressed as a range of value if so required by the terms of reference (as expressed in the scope of work).

STEP 7: COMMUNICATE FINDINGS

Communicating the analysis and conclusion is generally the last step in the valuation process. A report to the client can be communicated either orally or written; regardless, the same principles of appraisal apply.

Most reports are written and appraisers typically rely on one of three formats: narrative, short form narrative, or form report. The narrative report is the most complete type of report, whereas the short form narrative is, as the name implies, an abbreviated report with less narrative explanation than the full narrative report. The form report is an appraisal report presented on a standard form such as those required by financial institutions.

Regardless of the report format chosen, keep in mind that appraisers (or licensees) may be asked at any time to defend their estimate of value, even several years after they prepared the report. Therefore, where simple oral or written reports have been prepared, the appraiser should still maintain a detailed file of comprehensive working notes for each assignment. The notes should provide enough information for the appraiser to be able to explain and defend the estimate of value at any time in the future.

Different Forms of Reporting

Oral: A short, simple *oral report* is adequate when the circumstances or the needs of the intended user do not allow or warrant a written report. An oral report is used in court when presenting as an expert testimony examination-for-discovery or a deposition. In other situations, oral reports are communicated to the intended user in person or by telephone.

Form: A standardized *form report* combining check-off boxes and narrative comments is efficient, convenient and meets the needs of those intended users in financial institutions, insurance companies, and government agencies who review many appraisals. They are required for the purchase and sale of most homes and existing mortgages on residential properties in the secondary mortgage market created by government agencies and private organizations.

An example of a standardized residential appraisal form report, developed by the Appraisal Institute of Canada (AIC), is shown online on your Course Resources webpage.

Example

A mortgage lender may require an appraisal before granting a mortgage loan for a single-detached house. The common practice in this case is to provide a brief report using a prescribed form provided by the lender.

Narrative: A detailed narrative form follows the order of steps in the appraisal process. Its format allows appraisers the opportunity to support and explain their opinions and conclusions fully, and to convince the reader of the soundness of the final opinion of value. Narrative appraisal reports will vary in content and organization, but generally they contain four major sections: the introduction, the premises of the appraisal, the presentation of data, and the analysis of data and conclusions. A fifth section, the addenda, which includes supplemental information and illustrative material may also be included.

The organization of narrative reports varies, but the outline provided on the Course Resources webpage can be used as a general guide.

Example

An appraisal report may be prepared for litigation (e.g., expropriation). The report is required to be in writing and the appraiser, knowing he or she will be cross-examined, will have all the necessary supporting data readily available. The appraiser produces a lengthy and comprehensive narrative appraisal report.

Comparative Market Analysis

The Comparative Market Analysis (CMA): is a short form narrative style report that the licensee prepares for the seller of a property to establish an estimated market value and, in turn, a recommended listing price for the property. A licensee can also prepare a CMA for a buyer for the purposes of providing a well-researched suggested offer price. The CMA typically consists of a short direct comparison valuation: the licensee gathers data from the sales and listings of properties similar to the subject property (the property being listed for sale), and using this data, estimates a value for the subject property.

Typically, three to five comparable properties are used. A strong comparable property is one that shares many characteristics with the subject property, and that has recently sold in market conditions that are similar to present conditions. Listings can provide guidance on the pricing of potentially competitive properties.

comparative market analysis (CMA)
a short-form narrative style report prepared by a registrant for the seller of a property to establish an estimated market value and recommended listing price

A CMA is less detailed than a full appraisal report and its format is fluid. Some licensees might choose to keep a CMA short and simple (e.g., one to three pages), while others may decide to create a more detailed report. While the market value suggested in a CMA is primarily based on the comparable property data, adjustments are made based on additional information, including market conditions and trends, current listings, expired listings, local market knowledge, and a licensee's experience and expertise. The final suggested market value is determined using both objective and subjective factors.

The CMA represents an overview of the licensee's valuation of a property. Typically, it does not include as much information or as precise calculations as an appraiser's report. For example, in a direct comparison valuation, an appraiser will add or subtract specified dollar amounts to the comparable properties relative to the subject property, while the licensee will often simply indicate whether the comparable property is superior, inferior, or similar to the subject property. The written CMA is only one component within the package of information that a licensee presents to their clients. The licensee also needs to communicate market conditions, discuss local market particulars, and develop a marketing strategy. While a CMA might not include detailed area and regional overviews, in-depth discussions of supply and demand, and other sections included in an appraisal report, the licensee must still have sufficient knowledge in each of these areas. The licensee is responsible for completing full due diligence on a property and for communicating all findings to the client. CMAs and direct comparison valuations will be discussed further in Chapter 16.

As a Mortgage Broker...

Licensees might work with clients who have access to an appraisal report that has been completed for reasons unrelated to the sale of the property in current market conditions. A licensee should ensure that the client understands that appraisal reports are prepared for specific purposes, and that the value obtained for one particular purpose is not necessarily the same as the sales price of a property.

A licensee can help a client review the appraisal and assist in determining which sections of the appraisal are relevant, depending on the client's situation (buying or selling). The licensee that encourages the client to view the appraisal within its intended context is helping to create realistic expectations in terms of potential offers and the ultimate selling price of the property.

LEGAL CONSIDERATIONS FOR APPRAISAL

Considering the different interests and types of real estate and the features of the real estate market, it would be unreasonable to consider an appraisal to be more than an estimate of value. In many cases, value can never be established with any degree of certainty. This lack of accuracy is not only found in estimating property values; surveyors are allowed reasonable error, within limits, in measuring land. There can be no set limit of allowable error in appraisal work, because it will vary with the extent of the imperfections of the market as well as with the purpose and complexity of the appraisal. Where the objective of the appraisal is to find market value, the property is of a common type (e.g. a single-family residence), and there is sufficient evidence of recent sales, an error of 5% to 10% may be reasonable; alternatively, depending on the market and circumstances, this variation may be significantly too high or too low. For example, with an unusual property or a market with few participants, the margin of uncertainty may be much higher. The courts have recognized that a reasonable margin of error exists when calculating damages resulting from a negligent appraisal.

Example: Variance in Appraisals

An appraiser has estimated the market value of a house to be $560,000. If the property sold for $527,000 at the date of appraisal, was the appraiser's estimate of value reasonable?

This property sold for approximately 6% less than its appraised market value. Whether or not this can be considered reasonable depends on the subject and the market – is the market relatively stable or fluctuating significantly? Is there adequate recent sales evidence for similar properties? Are there any unusual circumstances or unique attributes that would explain this variance in value?

If a 10% margin of error was considered reasonable here, then a range of values could be stated as follows:

0.10 × $560,000 = $56,000

$560,000 – $56,000 = $504,000 lowest expected sales price

$560,000 + $56,000 = $616,000 highest expected sales price

Since the property's sale price is within this $504,000 to $616,000 range, this suggests the estimate of market value was reasonable in the circumstances (assuming the 10% margin of error is in fact reasonable).

Some definitions of market value incorporate the notion that appraisals are not exact and that the estimate of market value represents only one of many possible values. Value definitions usually include some version of "the most probable sales price". Implicit in this is the notion that several prices might occur but "the most likely one is … X dollars". Some appraisers provide a value range but the common practice is to provide a single figure estimating market value, recognizing this figure is subject to some degree of error.

Potential Sources of Liability

Almost no licensing requirements exist to govern the work of appraisers in Canada (Quebec excepted). In fact, section 2.8 of the Regulation to the *Real Estate Services Act* specifically exempts appraisers from the licensing requirements, provided the only trading service they are providing is the appraisal of value of the real estate and related consulting services.

In the absence of statutory regulations of appraisal, the Code of Ethics of the various appraisal organizations provides some guidance on the behaviour of appraisers. Each association has a reasonably comprehensive Code of Ethics. However, since membership in a particular association is not a requirement for the practice of appraisal, this provides only minimal control over the behaviour of member appraisers. For example, a serious breach of these ethics may result in a member being expelled from the particular association, but it does not prevent them from accepting appraisal assignments. Because many of these appraisal organizations are small and spread out, membership in any single organization is not very important to an individual appraiser; losing a single membership may have very little effect on the appraiser's ability to profitably continue as an appraiser.

As a result, the courts are left to monitor the performance of appraisers and provide some guidelines to the appraiser's legal responsibilities. These legal responsibilities are outlined in the law of contract and the law of tort.

Mortgage appraisals are examples where a carelessly prepared report may result in one action based on contract law by a person who had ordered the appraisal, and a second action based on the law of tort by another person who had relied on the appraisal. This is because the party that commissions the appraisal (lender) is not typically the party who pays for it (vendor/borrower). The appraiser's duty is to the lender, but the borrower often believes they are the client. This creates two issues:

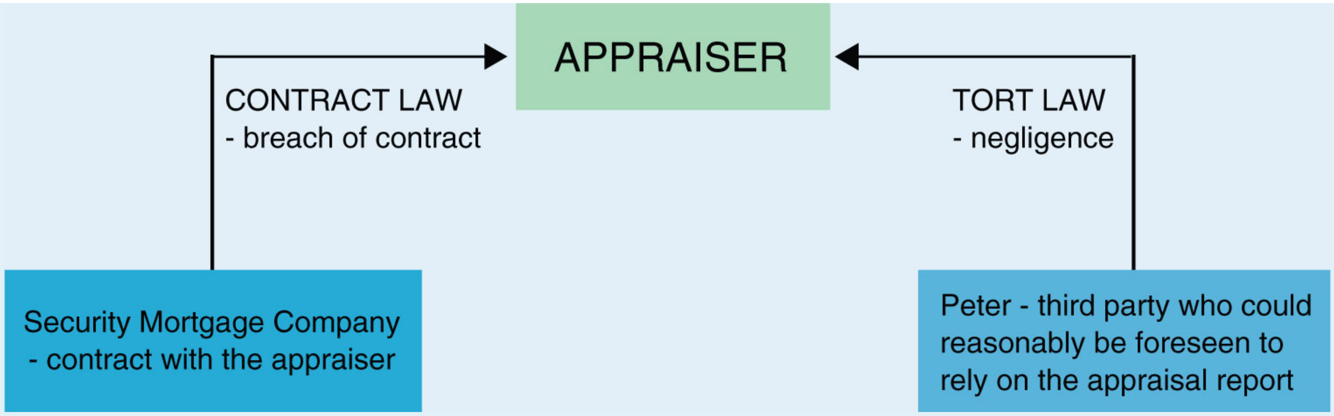
1. if there is a problem with the appraisal and the lender loses money, the lender can attempt to sue the appraiser, but the borrower cannot, as they have no contract with the appraiser; and
2. the borrower often requests a copy of the appraisal report, but the appraiser and lender are under no obligation to provide it, though it is common practice that they are given a copy. This often raises difficult questions when the market value is substantially different than the purchase price as in the following example.

Example

Peter has made an offer of $800,000 on a property subject to arranging suitable financing. Security Mortgage Company assures Peter they will lend him up to 80% of the appraised value of the property. To this end, Security hires an appraiser and asks him to determine the value of the property for the purpose of obtaining a mortgage on the property. The appraisal report indicates a market value of $800,000 and Security lends Peter $640,000.

Six months later, Peter encounters financial difficulties and Security Mortgage Company is forced to foreclose. The Company obtains two independent appraisals of the property to determine the best method of recovering the mortgage monies and both appraisals disclose a market value of only $580,000 at the time the property was purchased. These new appraisals suggest an error in the preparation of the original appraisal. The property is then sold in an arm's-length transaction for $580,000, leaving Security Mortgage Company with a deficiency on the mortgage of $60,000. Peter also suffers a loss of equity of $160,000 and he is still personally liable for the mortgage deficiency of $60,000. What actions could be taken against the appraiser?

Peter and Security Mortgage Company may take quite different actions against the appraiser that illustrate the distinction between tort law and contract law.



Security Mortgage Company may sue the appraiser for breach of contract. To be successful, Security must prove it had established a contract to have the appraisal report prepared and that an implied term of the contract was that the appraisal report be carefully prepared according to accepted appraisal practices. Security must also show the appraiser was aware the Company was contemplating lending money against the property and the Company's loss is foreseeable as the type of loss that could result from a carelessly prepared appraisal. Since it is foreseeable a mortgage lender would lend up to 80% of the appraised value of a property, Security could try to recover the deficiency from the appraiser.

Peter did not have a contract with the original appraiser and they may not have met. He will base his action against the appraiser on the law of tort; specifically, on the tort of negligence. Peter will argue it was foreseeable the appraisal report would be made available to the person purchasing the property and that, if the appraisal report is carelessly prepared, this person is likely to suffer a loss. For this reason, an appraiser owes a duty of care to those persons who he can foresee are likely to take action based on the appraisal report. Here, the appraisal report may have been carelessly prepared and Peter may recover those damages that can be reasonably expected as a result of the breach of the duty of care.

Disclaimers

Where the appraisal is done for a specific client and only the intended user identified in the report, the appraiser can assess the potential liability resulting from an error. It is much more difficult for him to identify and assess the likelihood of third-party liability so he should take steps to minimise such liability. While the appraiser may stipulate exclusion clauses or disclaimers in the appraisal in the appraisal report, it does not prevent liability for negligence. However, disclaimers might limit the number of parties to whom liability for such negligence is owed. Therefore, when preparing an appraisal, the following (or similar) disclaimer statement could be used and included in the report:

> This report may only be used by (name and client) and may not be used by him/her/them for any purpose other than (use that appraisal is prepared for) unless prior written permission has been obtained from (name of the appraiser).

Reliance Letters

Appraisers are frequently asked by a party, other than the one(s) intended at the time of the completion of the assignment, to rely on their report:

- a lender requesting authorization to use the appraisal for underwriting purposes, when the report had originally been prepared for a different lender;
- a report originally prepared for matrimonial purposes and a party wants to rely on it for refinancing; or
- one originally prepared for financing purposes being considered for a divorce settlement... the list is endless.

What can an appraiser do? They have three options: decline the request, write a new report or, issue a reliance letter. A reliance letter extends the original report; it carries the same pre-existing ability to claim, not to mention the risk for a claim from the original client, in the event of a breach of confidentiality. Hence, the appraiser, when issuing a reliance letter, should be aware of the added risk, and write it subject to the consent from the original client and release from the original intended user.

Expected Standard or Duty of Care

In *Windsor Motors Ltd. v. District of Powell River* (1969), 4 DLR (3d) 155 (BCCA), an officer of the plaintiff company visited Powell River to find a suitable location for a used car operation. He inquired at City Hall and was referred to the license inspector who examined a map, made a list of five possible locations, and gave the list to the representative of Windsor Motors. One of the locations was found to be suitable and a business licence was purchased for $35 to operate on that site. The lot was then stocked with used cars and the operation became profitable and successful.

City officials later discovered that the zoning for the selected location was for a service station and did not permit the operation of a used car lot. Windsor Motors was forced to move, at some considerable financial loss, and an action was commenced against the City based on the allegedly negligent statement of their official.

In confirming an award of damages for the car company, the court adopted the reasoning of the important English case of *Hedley Byrne and Co. Ltd. v. Heller and Partners Ltd.,* [1963] 2 AII ER 575 (HL):

> Quite apart from a contractual or fiduciary relationship, a negligent though honest interpretation, whether verbal or in writing, might form the basis of an action for damages for financial loss, as the law implies a duty of care when and where a party seeking information from one possessed of special skills trusted that person to exercise due care and the party who makes the representations knew or should have known that reliance was being on his skill and his judgment.

Clearly, the licence inspector did not have a contract with Windsor Motors. But he did supply them with incorrect information and, on this basis, the City was found liable to pay $4,655 in damages.

An appraiser faces a problem similar to that faced by the Powell River licence inspector. What do you do when called upon to supply information? The Court's answer is found in a passage from the *Hedley Byrne* case:

> A reasonable man, knowing that he was being trusted or that his skill and judgment were being relied upon, would, I think, have three courses open to him. He could keep silent or decline to give the information or advice sought; or he could give an answer with a clear qualification that he accepted no responsibility for it or that it was given without that reflection or inquiry which a careful answer would require; or he could simply answer without any such qualification. If he chooses to adopt the last course, he must, I think, be held to have accepted some responsibility for his answers being given carefully or to have accepted a relationship with the inquirer which requires him to exercise such care as the circumstances require.

As a Mortgage Broker...

The "reasonable appraiser test" is a common basis for determining if an appraiser's work was appropriate in the circumstances or if there may be professional negligence. Where an appraiser's work is in question, determine what a typical appraiser would do in the circumstances: what degree of due diligence in research and analysis would be considered acceptable? This sets the expectations for the appraiser in question. The same principle applies to licensee's completing their CMAs and helping clients negotiate purchase prices – the expected scope of work will depend on what is considered reasonable by professional peers completing similar work in similar circumstances.

Compensation for Negligent Valuation Reports

Baxter v. F.W. Gapp & Co. Ltd., [1938] 4 All ER 457 (KB)

In this case, an investor was considering making a mortgage loan on a property in Maidenhead, England. Since he was unfamiliar with the area, he hired an estate agent to complete an appraisal. After the property was inspected, the estate agent wrote to the investor's solicitors advising them that the property was worth £1,800. The solicitors then prepared the mortgage documents and were most surprised to find from their review of the abstract of title that the owners had paid only £650 for the property the previous year. While the solicitors gave this information to the estate agent, he still confirmed his original opinion of value. Based on this assurance, a mortgage for £1,200 was advanced. After six months, the mortgage was in default and the owner abandoned the premises. The investor took possession of the property and, after a great amount of effort, managed to sell it for £850.

The investor began an action against the estate agent, claiming the original amount of the mortgage of £ £1,200 plus accrued interest less the amount of £850 realized on the sale of the property. The plaintiff called, as witnesses, appraisers who were experienced in the particular area and their estimates of value ranged between £900 and £1,150. The defendant land surveyor admitted that he was not familiar with rental rates or recent sale prices in the area.

The court found that negligence had been established and then turned to the question of calculating the damages. Two approaches to calculating damages were discussed:

1. The first was to take the difference between the negligently prepared appraisal value and the actual value of the property at the date of the appraisal.
2. The second was to calculate the amount of loss suffered by the plaintiff as a result of his having relied upon the negligently prepared appraisal.

Where the plaintiff is a person who has purchased the property, the first approach is more applicable. In this case, however, the court awarded damages based on the actual amount of loss incurred as a result of their investment.

An important point stressed in this case is that over-valuation does not, by itself, establish liability on the part of the appraiser. As the court pointed out:

> The disparity of £950 between the valuation of £1,800 made in July, 1935 and the best price which could be obtained for the property when it was put to the test of sale in March 1938, less than 3 years after the valuation is certainly startling and calls for an explanation. There might have been some such explanation as has been suggested a general fall in values and, particularly, a depreciation in the value of bungalows in Maidenhead. No such evidence was given.

In other words, an apparent over-valuation on an appraisal shifts the burden to the appraiser to offer some explanation. If the over-valuation cannot be reasonably explained, the conclusion is that the appraisal was negligently prepared.

Bourne and Cox v. Martin (unreported)

In this case, the duty of a licensee who had been asked to provide an appraisal was examined.

In the spring of 1995, two sisters asked a real estate licensee to value six neighbouring 10-acre lots on Bridge Lake (the sisters were executrices of their mother's estate). Once value was established, the licensee was to list the lots for sale. The licensee stated that based on sales of similar properties, the market value of Lots 1 and 2 as of February 1994 was $35,000 each. He then listed the lots for sale at $35,000.

The listings garnered a lot of attention as most 10-acre parcels in the area were selling for around $40,000 at the time. In fact another licensee called the licensee's office and suggested the property was listed well below market value.

However, another licensee in the listing licensee's office presented an offer for the full price on Lot 2 which the sisters accepted. Immediately afterward, concerned the price was too low, the sisters told the listing licensee to hold off on any further listings until they could get a full appraisal. Six weeks later, the purchaser of Lot 2 flipped it for $65,000 to a purchaser who was buying the land surrounding Bridge Lake. The purchaser later bought Lots 1 and 3 from the sisters for $45,000 each.

The unhappy sisters sued the listing licensee in Small Claims Court for misrepresentation, negligence, breach of contract and breach of fiduciary duty and won the maximum $10,000 allowed. However, the case was appealed and was retried in the BC Supreme Court.

The decision was confirmed at the Supreme Court of BC, which held that the listing licensee hadn't done a proper valuation of the subject lots and if he had, he would have discovered the presence of a purchaser who was buying land surrounding the lake and may have concluded that he might have an interest in Lots 1, 2, or 3. The court also stated that "the defendant had a duty to the plaintiffs to provide a proper valuation and to give the guidance they asked for and needed in order to list the lots for sale. He was in breach of that duty."

ALERT

The *Baxter v. F.W. Gapp & Co. Ltd.,* and *Bourne and Cox v. Martin* cases clearly indicates that licensees face similar legal standards as that of professional appraisers. A key difference may be the scope of work – a professional appraiser carrying out valuation work for a fee may face a higher expectation for due diligence. However, the case makes it clear that licensees must exercise care in in valuing a property and in advising sellers on appropriate listing and selling prices for a property – or face potential legal consequences.

LOOKING AHEAD – INNOVATIONS IN PROPERTY VALUATION

It's essential for mortgage brokers to understand and anticipate the transformative potential of emerging technologies on property valuation. Automated Valuation Models (AVMs), artificial intelligence (AI), and blockchain are three significant advancements poised to reshape traditional property valuation practices. AVMs, with their ability to provide instant, data-driven property valuations, are already changing the speed and efficiency of valuation operations. AI further augments this process, introducing enhanced accuracy and predictive capabilities, while blockchain technology promises a future of transparent, secure, and streamlined property transactions and record-keeping. However, along with the opportunities, come challenges that will require careful navigation. Balancing these innovative tools with the nuanced expertise of human appraisers will be key to the effective property valuation practices in the future.

automated valuation models (AVMs)
a computer program that analyses large volumes of data using an automated process to estimate a market value.

Automated Valuation Models

Innovation in appraisal has mainly been driven by the need for lenders to obtain a large volume of property valuations in a faster, more cost-effective manner than through traditional appraisal reporting. One result of this growing need was the development of *Automated Valuation Models* (AVMs), defined as:

> A computer program that analyses data using an automated process that may include regression, adaptive estimation, neural network, expert reasoning and artificial intelligence programs.
>
> *Canadian Uniform Standards of Professional Appraisal Practice*

In the late 1990s, Canada Mortgage and Housing Corporation (CMHC) introduced emili,[2] an automated underwriting system for the CMHC mortgage insurance program. The immediate impact was reduced demand for conventional residential appraisal reports for high-ratio loans requiring insurance.

Since then, AVMs have evolved to offer a variety of real estate applications:

- Similar automated risk analysis tool offered by CMHCs' major competitor, Genworth Financial Canada;
- Emergence of large-scale public and private sector AVM providers, such as MPAC (Municipal Property Assessment Corporation) and reavs (Real Estate Automated Valuation System);
- Development of real estate information systems (title registry systems in BC and Ontario) by Macdonald Dettwiler Corporation and Teranet Enterprises; and
- Emergence of private sector online AVMs offering consumers pricing information, for a fee. Two examples are Landcor and Zoocasa – these could perhaps encourage more "For Sale By Owner" transactions as owners may feel more confident in pricing their property themselves. A sample portion of a typical Landcor residential AVM report is provided online.

AVMs are sophisticated technology-based systems that are transforming how real estate professionals understand and interact with the real estate industry, particularly within the mortgage sector. AVMs provide instant property valuations by using mathematical modeling techniques, which analyze various data including historical property transaction records, comparable property values, local market trends, and tax assessments.

As a mortgage broker, embracing the use of AVMs can offer several benefits such as speed and cost-efficiency compared to traditional manual appraisals. They also provide a valuable tool in scenarios like refinancing, home equity lending, portfolio management, and loss mitigation. However, while AVMs offer a significant boost to efficiency, it's crucial to remember they should not completely replace human appraisals. Their inability to inspect a property physically means they can't account for factors like very recent renovations or property damage. The accuracy of AVMs can vary based on the data used, the specific model, and market conditions. Therefore, they should be considered a part of your larger tool kit for property valuation and risk management.

AVMs and Mortgage Lending

Banks and other federally regulated financial intuitions (FRFIs) are subject to legislated guidelines for residential mortgage underwriting. The guidelines (B-20) specify the following for appraisal and AVMs:[i]

> …a proper and thorough assessment of the underlying property is essential to the residential mortgage business and key to adequately mitigating risks. FRFIs should have clear and transparent valuation policies and procedures in this regard.
>
> In assessing the value of a property, FRFIs should take a risk-based approach, and consider a combination of valuation tools and appraisal processes appropriate to the risk being undertaken. The valuation process can include various methods such as on-site inspections, third-party appraisals and/or automated valuation tools.
>
> Automated valuation tools: Where FRFIs use automated valuation tools, processes should be established to monitor their on-going effectiveness in representing the market value of the property. Controls should also be in place to ensure that the tools are being used appropriately by lending officers.

Advantages and Challenges of AVMs[ii]

Advantages	Challenges
• Saves time, money, and resources and helps manage the ever-increasing data stream, providing a level of certainty • Removes the human element, reducing the risk of fraud	• System can be subject to fraudulent activity • It cannot perform a physical inspection of the property, instead assuming an average condition that may not reflect reality • Lower performance applies with new build properties due to a lack of comparable properties and historic data • There is potential for disordered valuations if bad data is allowed to seep into the system

i *osfi-bsif.gc.ca*

ii RICS. "The Future of Valuations".

Commercial AVMs have been slower to respond given smaller numbers of commercial properties, in relation to residential property volumes. The low transaction numbers and unique nature of commercial properties have posed significant problems for AVM developers. However, assuming continued pressure for faster, more efficient real estate tools, and sufficient applications of time and money, there will be technological solutions to common types of commercial real estate in larger markets. Examples of properties that may be suitable for AVMs are strata or multi-tenant industrial properties, rental apartments, and small to medium office properties.

The long-term potential and acceptance of AVMs is largely subject to economic changes in mortgage markets. Their performance will be measured against actual loss by mortgage defaults, falling housing prices, and mortgage frauds just as their human counterparts have been judged in the past. Similar to conventional appraisals, AVMs simply offer another tool used to transact a specific type of business arrangement. Clients must consider and compare the balance of economy, efficiency, and quality in deciding which tool is optimal for their needs.

Artificial Intelligence

Artificial Intelligence (AI) is becoming increasingly integral in various industries, and property appraisals within the real estate sector are no exception.

artificial intelligence (AI)
a branch of computer science that involves the creation and application of software and algorithms to emulate human intelligence, learn from data, and perform complex tasks autonomously or semi-autonomously

AI uses complex algorithms to analyse and learn from data, improving its own performance over time without being explicitly programmed to do so. In the context of property appraisals, AI can quickly and accurately analyse vast quantities of data including sale prices, property features, market trends, location data, and more. This can provide a more comprehensive, objective, and instant valuation of properties than traditional human-driven methods.

Not only can AI enhance speed and accuracy, but it can also offer a level of predictive analysis, which is invaluable in forecasting future property values based on existing market trends. This ability can help mortgage brokers make more informed decisions regarding loan amounts and terms.

However, AI should not be viewed as a complete replacement for human appraisal. While AI can analyse data at scale, it lacks the ability to consider more subjective factors such as architectural style, quality of craftsmanship, and community perception – nuances that seasoned human appraisers can better understand. Additionally, the effectiveness of AI in property appraisal is highly dependent on the quality and comprehensiveness of the data it's fed, which can vary significantly.

For mortgage brokers, understanding the interplay between AI and property appraisals is key. AI brings with it the potential to revolutionize property appraisals, making them faster, more accurate, and potentially predictive. But it's important to balance these benefits with an understanding of AI's limitations, seeing it as a tool to enhance rather than replace human expertise.

Blockchain and Property Valuation

Blockchain technology is quickly moving from the peripheries of the technology world to center stage in various industries, including real estate. While blockchain is widely known as the underpinning technology for cryptocurrencies like Bitcoin, its potential extends far beyond this realm, with the ability to transform property appraisal and related processes of a mortgage broker.

blockchain
a decentralized and distributed digital ledger technology that securely records and verifies transactions across multiple computers, ensuring transparency, security, and immutability of data

Blockchain, essentially a secure, decentralized digital ledger, holds the promise of revolutionizing property appraisal by enhancing transparency, efficiency, and trust. At its core, the value proposition of blockchain in property appraisal is in its ability to provide a secure, immutable record of property-related information, which can be readily accessed and validated. This is particularly relevant in the context of property history. Traditional methods of sourcing and verifying property data can be laborious and error-prone. By contrast, a blockchain-based property record system can provide a comprehensive and irrefutable history of a property, including past transactions, renovations, appraisals, and ownership changes. For the mortgage broker, this could significantly streamline the process of collecting and verifying property information, allowing for more accurate and efficient appraisals.

Furthermore, blockchain opens up the possibility of tokenizing real estate assets. These tokens could represent fractions of property ownership, and their value could be directly tied to the appraised value of the property. This could pave the way for new financing and investment structures, adding another layer of complexity to the appraisal process. However, it's important to acknowledge the challenges and early stages of blockchain in real estate. Issues around regulatory acceptance, data privacy, and access to this technology, could slow adoption, while the complexity of real estate transactions can make the implementation of blockchain solutions difficult.

As a mortgage broker, familiarizing yourself with blockchain and its potential applications in property appraisal is key. Even if the widespread use of blockchain in the industry is some way off, understanding its potential will equip you to navigate and possibly lead the ongoing digital transformation of the real estate sector.

CONCLUSION

This chapter introduced real estate appraisal and a seven-step framework for the appraisal process. By considering what is being appraised, why and for whom, the appraiser is able to determine the scope of the appraisal and the level of depth required to complete the assignment. The processes of data collection and market analysis guide the appraiser in determining the subject's highest and best use – a concept fundamental in determining value, and in turn the most appropriate value approach to use in the assignment.

While a complete description of the market data and analysis steps may often be omitted from the final written appraisal report, it does not mean that the appraiser has not completed this process. Although the client may indicate that a simple and brief appraisal report is all that is required, the appraiser/licensee must still ensure an appropriate level of due diligence to provide a credible conclusion. Keep in mind that the valuation process and the formal documentation are two separate steps – even when the communication of results is brief, details of the complete valuation process must be available in a working file for future reference, should the appraisal conclusions be questioned later.

We concluded this chapter with some legal considerations for valuation work: tort law, standard of care and due diligence exercised when providing valuation advice. We also had a brief look at some recent innovations that may perhaps change how property valuation is completed in future. The following two chapters will illustrate the application of the three main appraisal approaches in more detail.

1 A number of provinces are presently reviewing the need for such licensing; Alberta, Quebec, New Brunswick, and Nova Scotia have implemented licensing in some form.

2 Emili is technically not an AVM since its main function is to assess overall borrower risk and not to determine a specific property value.