

Appraisal Basics

An appraisal of real estate is the valuation of the rights of ownership. The appraiser must define the rights he intends to appraise.

The appraiser does not create value, the appraiser interprets the market to arrive at a value estimate. As the appraiser compiles data pertinent to a report, consideration must be given to the site and amenities as well as the physical condition of the property. An appraiser may spend only a short time inspecting the property, however, this is only the beginning.

Considerable research and collection of general and specific data must be accomplished before the appraiser can arrive at a final opinion of value.

Due to the many types of value, such as Fair Market Value, Insurance Value, Tax Value and Value In Use, the need to precisely define the purpose of the appraisal is essential.

Appraisal Methods

An appraisal is an opinion of value or the act or process of estimating value. This opinion or estimate is derived by using three common approaches, all derived from the market. They are:

Cost Approach to value is what it would cost to replace or reproduce the improvements as of the date of the appraisal, less the Physical Deterioration, the Functional Obsolescence and the Economic Obsolescence. The remainder is added to the Land Value.

Comparison Approach to value makes use of other "bench mark" properties of similar size, quality and location that have been recently sold. A comparison is made to the subject property.

Income Approach to value is of primary importance in ascertaining the value of income producing properties and has little weight in residential type properties. This approach provides an objective estimate of what a prudent investor would pay based upon the net income the property produces.

Then, after thorough analysis of all general and specific data gathered from the market, a final estimate or opinion of value is correlated.

When to Order an Appraisal

There are many reasons to obtain an appraisal. The most common reason is for Real Estate and Mortgage Transactions, but we have compiled a list of other reasons you may need to order an appraisal:

- to obtain a loan.
- to lower your tax burden.
- to establish the replacement cost of insurance.
- to contest high property taxes.
- to settle an estate.
- to help you make one of the largest financial decisions in your life.
- to provide a negotiating tool when purchasing real estate.
- to determine a reasonable price when selling real estate.
- to protect your rights in a condemnation case.
- to allow you to obtain a qualified appraisal report.
- because a government agency such as the IRS requires it.
- you are involved in a lawsuit.

Home's Market Value

In the real world, very few individuals order appraisal reports to establish an offering price or to substantiate a purchase price. At the point that an offer to purchase (in a

typical residential transaction) is made, the price has been set by other parties, not the purchaser. The price has been determined by the seller, who wishes to obtain the highest price possible, or the agent, who receives a percentage of the price as compensation and often represents the seller in the transaction.

The real estate agent will typically perform a comparative market analysis (CMA). The appraisal laws in most states allow real estate agents to perform CMAs without an appraiser's license or certification. A CMA is a necessary part of the agent's preparation for a listing and consists of examining sales of properties in the area to arrive at a listing price. The reliability of the CMA depends upon the agent's experience and the characteristics of the property. The agent will suggest a selling price to the seller based upon the analysis. However, neither the seller nor the agent are bound by the results of the analysis, and the agent is not required to follow any formal procedure in completing the CMA. If a seller wishes to list the property at a price higher than the price suggested by the agent, then the agent may be forced to accept the listing at that price or risk losing a commission.

Purchasers believe that they are getting a good deal if they make an offer lower than the listed price. But how far above the market value was the property listed? 10%, 15%, maybe even 20% above the fair market value? A negotiated price of 10% less than the listed price on a property that was listed at 20% above its value is not a bargain. The agent cannot tell the purchaser that the offered price is higher than the value, or even higher than their own CMA. In most states, they must submit the offer to the seller.

The seller of a property may want to order an appraisal before listing the property. Of course, the cost of the appraisal is always a deterrent, especially if the seller knows that a buyer will pay for it when applying for a loan. But the

appraisal is often justified. The seller could lose a sale if the property appraised for less than the sale price when appraised by the appraiser.

Appraisal To Obtain Loan

Usually, individuals applying for a loan are only interested in obtaining the loan and unfortunately are not worried about the prudence of buying the property at the agreed price. In fact, many purchasers will try to encourage appraisers to increase the appraised value so that they can purchase the home regardless of its value.

The majority of real estate appraisals are requested by mortgage companies to validate the property's purchase price for loan purposes. Except for periods of very low interest rates when everyone is refinancing, most loans are for the purchase of real estate and ordered after a sale price is negotiated. Purchasers mistakenly assume that mortgage companies are looking after their interests in the purchase transaction.

The law states that if the mortgage company orders the appraisal, the appraiser is responsible only to the mortgage company. We expect mortgage companies to be prudent and they should be, but being prudent is protecting their interest, not necessarily the purchaser's. The mortgage company's position:

- It has two sources of repayment: the purchaser's income and the property.
- The responsibility to repay the loan is not based upon the property's value, so the purchaser is obligated to pay the note even if the property value declines to zero.
- The loan may be insured or guaranteed by a government agency.
- The government does not promise to pay the purchaser's debt if the property value is wrong.

- If the loan is greater than 80% of the value, a portion of the loan may be insured by a private mortgage insurer.
- There is no decrease in risk for the purchaser regardless of the loan-to-value ratio. The investment by the purchaser is the same, a mixture of personal cash and a loan that must be repaid.