All Three Appraisal Methods to be Used

All too often the appraiser will find instructions for an appraisal report will include the terms “all three appraisal methods to be used.” Unfortunately, other than the recognition that this is going to require more time spent on the assignment, the appraiser rarely recognizes the problems or risks involved in accepting this term.

Firstly, it should be noted that “all three methods” are not equally applicable to every assignment. Secondly, there are more than three methods of appraisal. In historical terms, however, appraisal practice has recognized that there are three main methods of appraisal, namely the Comparison Approach, the Income Approach, and the Cost Approach. Many older appraisal texts give the impression that all three methods should be used when appraising improved property.

However if reference is made to the Canadian Uniform Standards of Professional Appraisal Practice the requirement is to “describe and apply the appraisal procedures relevant to the assignment and to support the reasons for the exclusion of any usual valuation procedures. There is no mention within this Standard, or indeed throughout Standards as a whole, that all recognized methods be used.

More to the point the Appraisal Standards Comments clearly states that exclusion of a method of appraisal constitutes an EXTRAORDINARY LIMITING CONDITION that requires disclosure with reasoning. The exclusion of a relevant approach must not result in a report that is misleading.

For example excluding the Income Approach from a single family home assignment or the Cost Approach for an older dwelling would not be a departure from Standards, whereas eliminating the Sales Comparison Approach in either case most likely would be. Similarly omitting the Cost Approach for any new single family dwelling would constitute an EXTRAORDINARY LIMITING CONDITION that requires disclosure with reasoning for its omission.

Furthermore, there are, of course, other methods of appraisal that are commonly used, notably the Development or Residual Approach and the Discounted Cash Flow Approach, although the latter can also be included as a derivative of the Income Approach.

The selection of appraisal methods in any assignment is not intrinsically a difficult one. A problem results, however, in the slavish adoption of methods which are not justified. An appraisal report is
only as strong as its weakest part, and all methods of appraisal used must be appropriate, accurate and correctly applied. Unfortunately, this is not often the case and the method most likely to be used inappropriately is the Cost Approach.

*Most appraisers understand that cost does not always equal value and for that reason care must be exercised when considering use of the Cost Approach to value in an appraisal report. Clearly it is most applicable to new construction, special use properties or where there is an absence of market data or activity to support the more traditional approaches to value. The application of the Cost Approach must be in balance with market conditions and can be developed in appraisals where costs are accepted by the consumers and generally indicative of market value. On the other hand this value test may be excluded from the appraisal in markets where cost is significantly out of balance with overall market conditions and its exclusion is not misleading.*

While the Cost Approach is often wrongly included in many appraisal reports, there are other errors that occur in the selection of appraisal methods. The Comparison Approach is perhaps the only method in which the application is fairly consistent. However, its use is not always to be considered mandatory.

Again, where the property exhibits unique characteristics that make the application of the method difficult, the method should not be included. Too many times the approach is used without good evidence, reducing the whole credibility of the report.

In other instances, however, and often outside the major urban areas, the method is excluded on the grounds that there are no suitable comparisons in the area in which the subject is located. This is generally an occasion when the Cost Approach is substituted, despite the age of the building. In reality, in the absence of any local sales, it is often possible to use sales from other areas that have some element of similarity to the subject’s location, even if somewhat distant geographically. Adjustments can then be made for any difference in market conditions.

The Income Approach can also cause problems, but there should be one simple principle. If it can produce rental income, then an Income Approach must be *considered in the appraisal report*. There have been a number of cases, both before the Complaint Investigating Committee and the courts, where the appraisal has omitted the Income Approach, even though the property is, or has the potential to be, revenue-producing. Omitting such an approach hardly adds credibility to either the report or the appraiser, especially if the other side in the dispute includes the approach.

The use of Discounted Cash Flow (DCF) techniques is subject to a number of criticisms, and books have been written on the subject. However, a simple philosophy can eliminate its use in inappropriate circumstances. If the DCF is to be used to obtain an estimate of market value, then the technique must only be used when it is commonly used in the marketplace for that type of
property. For this reason, a case can be made for DCF techniques in valuing major shopping, office towers, hotels, etc., but not, it is suggested, for small retail strip malls, smaller apartment buildings and similar smaller investment property. In essence, if the marketplace does not use it, then how can it represent market value?

For potential development site valuation, the use of the Residual Approach is also one that has come in for some criticism. It is suggested that, to avoid errors, the Residual Approach should only be used when development of the site is not too distant, there is obvious demand for the resultant product, and there is at least some documentary evidence that such a development will be approved. Ideally, the development or subdivision plans should be available, all municipal consents obtained, and all necessary services available. It is certainly not desirable to take a piece of raw land, assume a potential development, and proceed to the Residual Approach. In addition, the Residual Approach should never be used without using the Comparison Approach in at least a “back-up” role. However, it is equally important, if the Residual Approach is not being used in the appraisal but there is a scheme in place, for the appraiser to reconcile the Comparison Approach with a “back-of-the-envelope” attempt at a residual to test the validity of the Comparison Approach and retain this documentation in the appraisal file.

In summary, unless the appraiser can justify the use of the method of appraisal to the Courts, the Professional Liability Insurance Program, or the Complaint Investigating Committee, DO NOT USE IT. It is no excuse that the client requested it. The client does not dictate to the appraiser the content of ANY appraisal report. If this causes a problem with the client, then the appraiser is duty bound to either decline the assignment or to provide adequate disclosure within the appraisal as to the limitations of the approach. Further the report must be clear that the value test was developed for the sole use of the client. The results of this value test should be discounted in the final value conclusion if in the opinion of the appraiser they are not relevant. To do otherwise is a contravention of our professional standards. At the very least, it could result in a claim of negligence against the appraiser which, even if successfully defended, can result in many months or even years of aggravation. The appraiser should ask, do I really want to spend months or years defending this appraisal?

CUSPAP References

Appraisal Methods

Appraisal Standard

6.2.16 In the report the appraiser must describe and apply the appraisal procedures relevant to the assignment;

6.2.17 In the report the appraiser must support the reason for the exclusion of any of the usual valuation procedures;
6.2.18 In the report the appraiser must detail the reasoning supporting the analyses, opinions and conclusions of each valuation approach;

6.2.25 In the report the appraiser must review and reconcile the data, analyses and conclusions of each valuation approach into a final value estimate;

**Appraisal Standard Comment**

7.17.1 When a direct comparison approach is applicable, an appraiser must analyze such comparable data as are available to indicate a reasonable value conclusion.

7.17.2 When a cost approach is applicable, an appraiser must:

7.17.2.i. develop an opinion of site value by an appropriate appraisal method or technique;

7.17.2.ii. analyze such comparable cost data as are available to estimate the cost new of the improvements (if any); and

7.17.2.iii. analyze such comparable data as are available to estimate the difference between cost new and the present worth of the improvements (accrued depreciation).

7.17.3 When an income approach is applicable, an appraiser must:

7.17.3.i. analyze trends, forecasts and such comparable rental data as are available to estimate the market rental of the property;

7.17.3.ii. analyze such comparable operating expense data as are available to estimate the operating expenses of the property;

7.17.3.iii. analyze such comparable data as are available to estimate rates of capitalization and/or rates of discount; and

7.17.3.iv. base projections of future rent and expenses on reasonably clear and appropriate evidence.

**Practice Notes**

12.36.1 A contract sale price of the subject property can be a good indicator of its market value, and it may be logical and reasonable for the appraiser to conclude that they are the same. However, this is not always the case. In some situations, the subject contract price may exceed or be less than what is typical in a market. A contract sale price, while a significant piece of market data, must not become a target in an appraisal assignment.

12.36.2 Care should be exercised in analysing sales of new properties to ensure both consistency and disclosure regarding the impact if any of transaction taxes (e.g. GST) on prices paid. (GST may already be included in the model of basic cost multipliers provided by valuation costing services.)
12.36.3 Fixing the date of sale of a comparable is necessary to establish relevance and accuracy, and to determine the precise period for which a time adjustment is to be made. This adjustment period begins on the date of sale and ends on the effective date of the appraisal.

12.36.4 The date of sale could be taken as:
12.36.4.i. the time of the meeting of the minds
12.36.4.ii. the execution of an interim agreement
12.36.4.iii. the removal of subject to clauses
12.36.4.iv. acceptance of an offer to purchase
12.36.4.v. multiple listing record
12.36.4.vi. execution of title transfer by the vendor
12.36.4.vii. registration in the land title office

12.36.5 Practical considerations may determine which date is to be used. Dates of record reflecting completed transactions provide certainty, and – in most jurisdictions – are readily available. But weeks or months could have elapsed since the initial agreement as to price. And confirming the date of this initial agreement requires that the parties be available – and willing – to divulge details.

12.36.6 In a period where the market is rising or falling at a substantial percentage each month, it may be necessary to reflect whether the sale occurred near the beginning, in the middle, or at the end of the month.

12.36.7 In selecting the date of sale, consistency is the preferred approach. Rather than attempting to speculate as to the length of the interval between agreement and closure, less weight can be given to those sales dates that are inconsistent with the model selected.

12.36.8 In summary, while it may be argued that no sale has occurred until the transfer is registered, there may be a long delay in registration. The basic answer to the question - “what is the date of sale” - is the date the price was finally agreed upon. Researching that date for all of the comparables may be impractical. Where consistency is not possible, any variation should be explained.

12.36.9 Sales occurring after the effective date of valuation may be useful in the analysis but are subject to appropriate weight.
Canadian Appraiser Magazine Reference

Putting It Right with the Direct Comparison Approach, Vol 49, Book 2, page 42, 2005
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