

# Guide Notes to the Standards of Professional Appraisal Practice of the Appraisal Institute

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# Valuation of Real Estate Component of Real Estate Limited Partnership Interests

## Introduction

The limited partnership has become a recognized form of ownership. Creation of such a partnership often begins when an individual or group (the general partner) purchases interests in real estate for the purpose of transferring them to a limited partnership. Problems may arise when an appraiser is asked to value the real estate interests at the time of their purchase by the general partner because this purchaser frequently is buying more than an interest in real estate. Problems also arise when the general partner sells these limited partnership interests because of the inherent difficulty in separating the value of the interest in the real estate from the aggregate value of the limited partnership interest.

The value of the interests in real estate at the time of acquisition by the general partner sometimes may be referred to as *wholesale value*. The aggregate value of the individual limited partnership interests sold by the general partnership is sometimes referred to as *aggregate market value* or *retail value*. If used by an appraiser, these terms must be defined clearly and precisely so that the intended users of the report will not be misled.

Valuation problems often relate to non-real estate items or conditions involved in the transaction such as special financing and guarantees of occupancy or income. These items are difficult to isolate and evaluate even when all the facts are known. In the context of limited partnership purchases, the problem of analyzing comparable sales becomes more difficult than usual due to the difficulty in obtaining all the relevant data.

When a general partner sells a real estate limited partnership interest, the price of this limited partnership interest may include management services and other benefits in addition to the interests in real estate.

The sale of a limited partnership interest in real estate involves the marketing of a highly specialized interest, both real and personal, to a specifically defined group of purchasers having varying motivations. Unless extreme care is taken to distinguish the exact nature of the interests being appraised, valuation conclusions can be greatly distorted or misleading, and an appraiser may become liable under security and tax regulations that have often been described as punitive.

## Basis for Proper Evaluation

All applicable approaches should be considered in developing an opinion of value. When analyzing comparable sales in the sales comparison approach, all transactions should be specifically analyzed to determine whether non-real estate items were included in the purchase price. If non-real estate items were included, they should be separately identified and their effect on the sale price should be carefully considered and measured.

General partners frequently assert that the aggregate price paid for a limited partnership interest represents the market value of these interests in real estate. This may be an important item since this value may be used to establish the basis for certain tax benefits. The appraiser must carefully analyze the aggregate sale prices of the limited partnership interests and separate the value of these interests in real estate from the contributory value of the non-real estate interests. Rarely would the retail price of individual partnership interests sold equal the market value of the interests in real estate. It is essential that the appraiser understands that the partnership interests sold include non-realty items such as management services, investor-specific tax benefits, the ability to invest in a major property that an investor might be incapable of investing in alone, and the potential for improved liquidity. Potential capital appreciation and possible tax benefits are considered to be elements that influence investors and may impact the price paid.

When valuing fractional interests in a real estate partnership, an appraiser must be certain that the market data is comparable, and be acutely aware of the details of transactions analyzed in the valuation process. In this connection, an appraiser can appraise the partnership interest involved either by breaking it down into separate components, or by considering it as a whole with all the components properly identified.

### **Summary of Standard Practices**

1. Identify non-realty items that are included in the appraisal and analyze their effect on value (S.R. 1-2(e)(iii) and S.R. 1-4(f)).
2. Determine the extent of non-realty items included in the price of each comparable sale.
3. Specify in the report that the difference between market value and aggregate retail value of the real estate interests being appraised is not the retail price of the aggregate fractional interests in the partnership, or the aggregate market value of the partnership (S.R. 1-2 (e)(v)).
4. Describe and measure the effects of non-market or atypical financing on the value of the real estate interests being appraised (S.R. 1-2 (c) and S.R. 2-2(a)(v) and 2-2(b)(v)).
5. Identify and analyze the value of any non-real estate items included in the appraisal (S.R. 1-4(g)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

## Cash Equivalency in Valuations

### Introduction

Standards Rule 1-2(c) requires that for opinions of market value the appraiser ascertain whether the value is to be the most probable price in terms of cash, in terms of financial arrangements equivalent to cash, or in other precisely defined terms. Standards Rule 1-2(c) further requires that if the opinion of market value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified and the appraiser's opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.

The definition of presumed mortgage conditions is an explicit or implicit instruction of the appraiser's client. The instruction may mirror a loan commitment or only sought conditions. The presumed financing may be prospective or existing. There may be more than one presumed mortgage. Components of financing include the amount of the mortgage loan(s), its interest rate(s), its interest payment interval(s), its schedule(s) of debt repayment, required fees for placing the loan(s), and required restrictions or fees for early termination of the loan(s). Any of the components can diminish or enhance market value.

An opinion of market value may presume "all cash," meaning no financing, i.e., that the real estate is debt free at the time ownership is transferred. More likely, the presumption will be "all cash to the seller," meaning the buyer mortgages the real estate as security to a third-party lender who pays part or all of the price in cash; if the financing is part of the price, the non-mortgaged amount is paid in cash by the buyer. In some cases the presumption will be that the seller will partially or entirely finance the purchase, i.e., will "hold paper," meaning take back the buyer's purchase-money mortgage. This could be instead of or in addition to a third-party loan.

Each comparable transaction, the financing of which differs from that presumed for the appraised property, should be adjusted to parity. For example, assume that the property is to be appraised presuming an 80%, self-amortizing, 300-month, 0.677% monthly interest rate loan available to a qualified borrower for the pre-payment of three percent of the loan amount (three placement points). If the loan conditions for one of the comparable sales were identical in each respect except that four placement points were paid, an 0.8% (one point times 80%) increase in the price of that comparable would accommodate its financing difference.

Appraisers, when calculating financing adjustments, often substitute the expected remaining loan term until a logical refinancing date for the longer total loan term.

Many appraisers find it an orderly process to first adjust and analyze each comparable price to its arithmetic equivalent of an all-cash-to-the-seller price. Then, if necessary, they adjust the cash-equivalent conclusion of the comparable prices to the presumed financing of the appraised property. Even when the presumed financing is other than cash-equivalent, this process is favored to reveal the quantified total effect of the financing. (The expression "cash equivalent" pertains to the seller's point of view; a loan is not the true equivalent of cash to a purchaser who does not have the alternative of paying cash.)

When appraisers refer to “favorable financing,” they mean favorable to the buyer. Such financing may be unfavorable to the seller but often it is a matter of indifference to the seller.

When the value to be developed for the subject property is market value based on cash, or financing that is equivalent to cash, comparable sales used in the sales comparison approach must be analyzed and adjusted for financing that may have influenced their prices.

A client may request a market value opinion on the assumption that specific financing, other than cash-equivalent, is available. Or the client may request that the property be valued with existing financing. In such cases, the appraiser should be careful to use a market value definition that is consistent with such an assumption. Further, the appraiser must analyze the effect of such financing; it may have no effect on the resulting value, or it may have a favorable or an unfavorable effect.

In responding to the questions posed by the client that initiated the appraisal assignment, the appraiser must adhere to ethical standards and fundamental appraisal principles and practices that are applicable to the market. A clear understanding is necessary between the appraiser and the client as to the interest being valued and the need for the appraiser to analyze existing, available, and/or proposed financing. If the appraisal assignment is to develop an opinion of market value, the definition of market value must not only be consistent with the client’s needs but must also meet the requirements of Standards Rule 1-2(c) as quoted below.

Standards Rule 1-2

- (c) identify the purpose of the assignment, including the type and definition of the value to be developed; and, if the value opinion to be developed is market value, ascertain whether the value is to be the most probable price:
  - (i) in terms of cash; or
  - (ii) in terms of financial arrangements equivalent to cash; or
  - (iii) in other precisely defined terms; and
  - (iv) if the opinion of value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified, and the appraiser’s opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.

Comment: When the purpose of an assignment is to develop an opinion of market value, the appraiser must also develop an opinion of reasonable exposure time linked to the value opinion.

### **Basis for Proper Evaluation**

The market value of a clearly identified property interest may be reported in a number of ways: 1) cash, 2) terms equivalent to cash, or 3) with other precisely defined terms. An example of such other terms is the cash value of the equity interest subject to existing or proposed financing.

Standards Rule 1-2(c) requires an appraiser to clearly define the terms of such financing and develop an opinion of their contributions to or negative influence on value. Standards Rules 2-2(a)(v) and 2-2(b)(v) require that, if the value opinion is market value, the report state whether it is in terms of cash or of financing terms equivalent to cash, or based on non-market financing or financing with unusual conditions or incentives. Further, if the opinion of market value is not in terms of cash or based on financing terms equivalent to cash, the report must summarize the terms of such financing and explain their contributions to or negative influence on value. The appraiser can either:

Report two values (as financed and cash-equivalent); or

Report one value and indicate the positive or negative influence the financing terms have on the value reported.

Standards Rule 1-2(c) contains this reporting requirement so that interested parties will be aware of how much the favorable or unfavorable financing impacts the value reported. Standards Rule 1-2(c) does not imply that different financing terms will always lead to a different value. It simply requires that a proper analysis be made.

### **Subject Analysis When Financing May Affect Value**

When developing an opinion of the value of a property, the appraiser must ascertain whether or not any existing financing is assumable, retirable, or replaceable. Also, the appraiser must estimate the potential value impact of the cost items such as finder's fees, points, and prepayment penalties and the effect of the present worth of participation by lenders, if any. The appraiser should also judge the duration of any favorable or unfavorable influence from mortgages or participations. It should not be assumed that the benefits or detriment due to financing will continue throughout the stated amortization or participation terms. The value impact of a mortgage fluctuates as interest rates rise and fall. The possibility of retiring unfavorable financing prior to its full payout period should also be considered.

Once a property owner finances the property, ownership may become subject to the terms of the mortgage. The sum of the value of owner equity and the face amount of the balance(s) of the mortgage note(s) may or may not be equal to the free and clear value of the property. Any difference represents the impact that the financing has on the value. The value of a property on the basis of cash or cash equivalency can be developed most directly by comparing it with similar properties that were being sold for cash or its equivalent on the open market. However, if the total consideration for a comparable sale includes something other than cash, e.g., the exchange of property, life tenancy, or other interest, such consideration should be converted to cash equivalency. Analyzing cash equivalency goes beyond the discounting of debt encumbrances.

If sufficient data to permit a direct market comparison is not available, the cash equivalency of existing or proposed financing can be estimated by discounting the contractual terms at current market rates or yield rates for the same type of property and loan term over the expected holding period of the property. However, such mathematical methods should be weighted against other market indications.

### **Comparable Analysis When Financing May Have Affected Value**

The same analysis outlined above must also be applied to comparable sales data. The appraiser should ascertain the terms of the financing involved in the acquisition of a comparable property and estimate the influence of such financing, if any, on the sale price. For example, does an all-cash sale differ from a sale in which the buyer assumed existing financing or secured new financing from the seller, a third party, or both? If so, why and what is the impact on price?

A clear distinction must be made between sale prices that are not affected by financing or other considerations, including sale prices for terms considered by the seller to be equivalent to cash transactions, and sales involving premiums or discounts due to financing. If the financing is unfavorable to the purchaser, one way that the difference may be measured is by the cost to retire the debt. Furthermore, the effect of financing on each comparable sale must be considered in light of the market as of the date of the sale, not the date of valuation of the subject. The appraiser should attempt to determine whether or not, at the time of sale, the financing affected the sale price in the minds of the parties to the transaction. If it did, the effect must be analyzed and an adjustment must be made and reported.

### **Summary**

In summary, demonstrated knowledge of the market financing available to the subject and comparable sale properties, analytical judgment, and common sense are required of the appraiser in determining whether or not specified financing impacts the value reported.

Standards Rule 1-2(c) requires that an opinion of the impact of favorable or unfavorable financing on market value be developed and Standards Rules 2-2(a)(v) and 2-2(b)(v) require that it be reported. The value reported must be clear and meaningful to the client and cannot be misleading to the intended users.

When non-market financing or financing with unusual conditions or incentives is involved and results in an effect on the value opinion, the appraiser can either:

Report two values (as financed and cash-equivalent); or

Report one value and indicate the positive or negative influence the financing terms have on the value reported.

### **Summary of Standard Practices**

1. Accurately report the specific terms of any non-cash-equivalent existing or proposed financing of the subject property, when such financing has an impact on the appraisal problem (S.R. 1-2(c)).
2. Analyze and report the effect of favorable or unfavorable financing terms on value (S.R. 1-2(c)).
3. Analyze and make appropriate adjustments to a comparable sale that included favorable or unfavorable financing terms as of the date of sale, when comparing the sale to the property being appraised (S.R. 1-2(c)).
4. Either report two values, or report one value and quantify the positive or negative influence the financing terms have on the value reported (S.R. 1-2(c)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

# The Use of Form Appraisal Reports for Residential Property

## Introduction

Most residential appraisal assignments require a report on one of the approved forms used in the secondary mortgage market or by the employee-relocation industry.

Use of such forms does not lessen or change the appraiser's obligation to observe the requirements of the Standards of Professional Appraisal Practice. If a proposed appraisal assignment cannot be completed in accordance with the appraisal development and reporting requirements of USPAP and the Certification Standard and Code of Professional Ethics of the Appraisal Institute, the assignment must not be accepted.

## Basis for Proper Evaluation

When using any form report, or signing a form report as a reviewer, it is the responsibility of the appraiser and the reviewer to ensure that the appropriate methods and techniques have been properly employed. Appropriate addenda must be added when additional information is required to complete the appraisal report in accordance with Standard 2 of USPAP.

Highest and best use appears on most forms merely as a box to be checked because the use of the form itself is a statement of highest and best use. Unless a detailed explanation is added to clarify, it is inappropriate to use a single-family dwelling report form if the appraiser concludes that the highest and best use of the property is a different use.

## Summary of Standard Practices

1. Consider the intended use, purpose, definitions, assumptions, conditions, and limitations that are inherent in the form report used for a residential appraisal (S.R. 1-2 (a) through (h)).
2. Sign an appraisal report as a reviewer only when accepting full responsibility for the contents of the report (S.R. 2-3 and Standard 3).
3. Analyze and report any prior sales of the property being appraised within three years of the date of the appraisal (S.R. 1-5(b)(i), S.R. 2-2 9a) (ix), and 2-2(c)(ix)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

# Reliance on Reports Prepared by Others

## Introduction

In this Guide Note an analysis, opinion, or conclusion prepared by others, and upon which an appraiser relies, is referred to as a “report.”

Appraisers often rely, at least in part, on reports prepared by others. Reliance on the reports of others generally increases with the complexity of the appraisal problem. The use of such reports may increase in the future. Appraisers are providing more specialized services and will need more information to make decisions and develop their appraisals.

Reports prepared by others vary in form, content, and applicability. Although they are frequently used in conjunction with proposed properties and transactions, they may also be applicable to existing properties and used in special situations such as litigation and arbitration.

In general, these reports fall into four major classifications:

### *General Informational Reports*

General informational reports are usually descriptive in nature and provide information pertaining to an overall area. They include data on demographics, economic trends, and other such matters. They are not specific to the property being appraised.

### *Reports Prepared by Licensed or Certified Non-Real Estate Appraisal Professionals*

Reports prepared by licensed or certified non-real estate appraisal professionals are specific to the subject property and may be either descriptive or factual in nature. They include engineering services, environmental studies, soil reports, impact studies, survey reports, zoning opinions, audited financial statements, and other reports relating to matters beyond the scope of appraisers’ expertise, or services not typically offered by appraisers.

### *Reports Prepared by Other Non-Real Estate Appraisal Professionals*

Reports in this category are prepared by experts who are not licensed or certified but have specific experience or expertise that an appraiser may rely upon. Examples include reports pertinent to the appraisal problem from academicians, operators of special use properties, and personal property valuers.

### *Other Reports*

Other reports pertaining to the subject property may be prepared by the client, by another real estate professional, or by others. These reports include financial statements, rent rolls, prior appraisal reports on the subject property, highest and best use studies, rental surveys, computer programs (or other electronic media), cost studies, and others.

## **Basis for Proper Evaluation**

Before relying upon reports prepared by others the appraiser must consider:

1. the criteria under which the reports were prepared;
2. the source and extent of the instructions given to the preparer of the reports;
3. how the appraiser might rely on this information in making decisions and preparing his or her report; and
4. the process and procedures used to evaluate the reports prepared by others.

The valuation process may require projections which are influenced by uncertain events. For this reason the basis for all assumptions and projections employed by the individual who prepared the report must be understood and properly utilized by the appraiser.

Standards Rules 1-1(b) and 4-1(b) state that the appraiser must not commit a substantial error of omission or commission that significantly affects the appraisal or the appraisal consulting assignment. Standards Rules 1-1(c) and 4-1(c) state that the appraiser must not make a series of errors that, although individually might not significantly affect the results, in the aggregate affect the credibility of those results.

Standards Rules 2-1(a) and 5-1(a) require that each written or oral appraisal or appraisal consulting report clearly and accurately set forth the assignment results in a manner that will not be misleading. Standards Rules 2-1(b) and 5-1(b) require that each written or oral appraisal or appraisal consulting report must contain sufficient information to enable the intended users to understand the report properly. Standards Rules 2-2(a)(viii), 2-2(b)(viii), 2-2(c)(viii), and 5-2(g) require that each written appraisal report or appraisal consulting report state all assumptions, hypothetical conditions, and limiting conditions that affect the analyses, opinions, and conclusions. Standards Rules 2-2(a)(ix) and 2-2(b)(ix) require the appraiser to describe or summarize in the appraisal report the information analyzed, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions. S.R. 5-2(h) requires the appraiser to summarize, in the appraisal consulting report, the information used in the appraisal consulting analyses, the appraisal consulting procedures applied, and the reasoning that supports the analyses, opinions, and conclusions. S.R. 2-2(a)(vii), 2-2(b)(vii), 2-2(c)(vii), and 5-2(f) require the appraiser to address the assignment's scope of work in the appraisal or appraisal consulting report.

Market value opinions should be supported by market-derived data and assumptions made should be specific to both the market and the property. An appraiser who accepts the projections or assumptions of others without some assurance of the accuracy or reasonableness of the calculations or information provided may violate the aforementioned Standards Rules.

The need for review and assurance of the accuracy or reasonableness of reports prepared by others will vary with their content and applicability. The scope of review or verification required depends on the scope of the assignment, the appraiser's level of expertise (if any), the type of information used, and the relevance of the information to the opinions and judgments rendered.

The four major classifications of reports require varying levels of review and care on the part of the appraiser, as offered below:

*General Informational Reports*

General informational reports usually require limited verification. Most discrepancies are easily clarified.

*Reports Prepared by Licensed or Certified Non-Real Estate Appraisal Professionals*

Reports prepared by licensed or certified non-real estate appraisal professionals typically offer conclusions as to the adequacy of a specific property component or issue pertaining to the property. These conclusions are generally based on accepted procedures or standards and represent informed opinions on matters beyond the appraiser's expertise. Absent reasonable doubt, these reports usually can be accepted conditioned upon the qualification that they were prepared by recognized professionals. Should observed or apparent material discrepancies exist between the appraiser's investigation and the submitted report prepared by a licensed or certified non-real estate appraisal professional, such material discrepancies must be disclosed.

*Reports Prepared by Other Non-Real Estate Appraisal Professionals*

An appraiser's reliance on reports prepared by these experts is distinct from that of the preceding paragraph in the greater care the appraiser should exercise in determining the pertinent expertise of the author.

*Other Reports*

Other reports prepared by, or at the direction of, the client, other real estate professionals, or others, require a careful review for reasonableness. To the degree possible and practical, computer programs or other electronic media should be reviewed for errors or inconsistencies. The level of investigation should be appropriate to the problem. The appraiser must understand the assumptions on which these reports are based as well as their applicability and validity to the assignment.

## **Summary of Standard Practices**

1. Become familiar with any report prepared by another that is relied upon in the appraisal process and, to the degree possible, understand the basis for its conclusions. Address any questions with the preparer of the report prior to using it in the appraisal process.
2. In conjunction with the scope of work for the assignment, identify or reference in the appraisal report any report prepared by another that was relied upon in developing the appraisal or appraisal consulting opinion or conclusion (S.R. 2-2((a)(ix), S.R. 2-2(b)(ix), S.R. 2-2(c)(ix), and S.R. 5-2(h), as well as S.R. 2-2(a)(vii), 2-2(b)(vii), 2-2(c)(vii) and 5-2(f)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

# Appraisals of Real Estate with Related Personal Property, Business Property, or Intangible Assets

## Introduction

Real property sometimes has associated with it certain items of personal property, business property, or intangible assets. Real property appraisers may be requested to appraise these items in conjunction with the real property. The valuation of personal property, business property, or intangible assets requires specific expertise. Before accepting such an assignment, an appraiser must first ascertain that he or she has the expertise to competently complete it. The valuation of the personal or business personal property may require the expertise of a personal property appraiser who specializes in that discipline.

## Basis for Proper Evaluation

In developing a real property appraisal, appraisers are required by S.R. 1-2(c)(iii) to identify “any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal.” S.R. 6-2(f)(i) makes the same requirement regarding mass appraisals. Further, S.R. 1-4(g) requires that when the scope of work warrants such analysis, the appraiser must analyze the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal. The Comment to S.R. 1-4(g) states:

Competency in personal property appraisal (see Standard 7) or business valuation (see Standard 9) may be required when it is necessary to allocate the overall value to the property components. A separate valuation, developed in compliance with the Standard pertinent to the type of property involved, is required when the value of a non-realty item or combination of such items is significant to the overall value.

Whether or not the value of the non-realty item is “significant” to the overall value depends on the specific circumstances and must be judged on a case-by-case basis by the appraiser.

Fixtures that are not real estate are identified as trade fixtures, domestic fixtures, and leasehold improvements. They are personal property regardless of ownership, regardless of who purchased or installed the item, and regardless of how securely the item is attached to the real estate.

Usually, trade fixtures for business, and domestic fixtures for residences, are installed by or for occupants who at occupancy-conclusion may forfeit them, sell them, remove them, or abandon them, depending upon 1) the lease or sale contract, 2) the contribution made when installed, 3) their investment value to the departing occupant, 4) custom, and 5) other considerations. For example, in a plumbing contractor’s establishment, there may be three categories of toilets: those used by the staff and customers are fixtures, i.e., real estate; those on display, built into model bathrooms, are trade fixtures, i.e., real estate related personal property; and those in the rear storage area available for delivery to, and installation in, customers’ buildings (where, when affixed, they will then become part of the real estate) are inventory, i.e., personal property that is not yet related to any real estate.

Leasehold items differ physically from trade/domestic fixtures in that they are constructed on site rather than merely installed (or modified and installed). For example, a tavern's bar might be constructed on the premises whereas the barstools would merely be installed as delivered. Such distinctions are not useful in the appraisal analysis, although a client may have some other justification for differentiation.

Local custom regarding whether an item is considered to be realty or personal property is of great importance regarding carelessly drafted purchase contracts. For example, where the contract is silent, a dwelling's refrigerator would be conveyed with the real estate in some jurisdictions but would not in other jurisdictions. The nearby table lamp, which is affixed to the real estate in exactly the same manner as is the refrigerator (by electric plug), is not real estate in any jurisdiction. Other personal property items in dwellings may include fireplace inserts, window treatments, and satellite dishes.

A securely affixed item may revert to realty at occupancy-termination, if its relocation requires prohibitively expensive damage to itself (e.g., partitioning) or to the building in which it is located (e.g., a wall safe). The value contribution at that time may be negative or positive, depending upon the nature of the item and demand for it at its location.

Most single-family dwellings, factories, amusement facilities, farms, and ecclesiastical properties, and many office and retail buildings are appraised to include some affixed tangible personal property (e.g., bookshelves, carpet). But, often, some items of affixed personal property are to be removed (or separately sold) by the grantor and should be excluded from the appraisal opinion. In all such cases, specificity is necessary. It is of great importance to the appraiser whether, for example, the gas range, the leaded stained glass window, and the dining room light fixtures are to be included in, or excluded from, the appraisal opinion. On the other hand, the contributory value of these items in no way depends upon whether each or any of the items is legally real estate or personal property.

In those cases in which the intended use of the appraisal assignment is related to some types of government activity, such as ad valorem real estate taxation, or eminent domain, the appraiser may be instructed to exclude all personal property. In those cases, the appraiser should either know how to comply, or find out how to comply with this legal instruction.

If the appraisal opinion is to include personal property that is either superior or inferior to that typically found in competing properties, allowance for the difference, on a contributory basis, should be considered in whatever procedures are appropriate to appraise the real estate and its related personal property.

If the appraisal opinion is to omit personal property that is integral to operating the real estate for its highest and best use, then comparable sale adjustments, cost summations, and income stream analyses should reflect that fact.

### **Summary of Standard Practices**

1. Develop an appraisal of real estate and related personal property only after ascertaining adequate knowledge and experience to complete the assignment competently (Competency Rule).
2. Identify any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal (S.R. 1-2(e)(iii)). Analyze the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal, when the scope of work for the assignment warrants such analysis (S.R. 1-4(g)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

# Consideration of Hazardous Substances in the Appraisal Process

## **Introduction**

The consideration of environmental conditions along with social, economic, and governmental conditions is fundamental to the appraisal of real property. Although appraisal literature has long recognized environmental conditions as major determinants of value, the focus has been on the consideration of climatic conditions, topography and soil, the surrounding neighborhood, accessibility, and proximity to points of attraction. These environmental conditions are readily apparent to a member of the general public who is not specifically trained as an expert in observing these forces. There is, however, a growing need to give special consideration to the impact of hazardous substances on the valuation of real property.

The growing need to consider hazardous substances is a recent trend stemming from the creation and identification of new hazards, relatively recent federal and state legislation enacted to control and place responsibility for these hazards, and an increasing public awareness of the problems resulting from these hazards.

The presence of hazardous substances can significantly impact the value of a property. In fact, in some cases the remediation cost may be greater than the property value after any necessary clean-up.

For the purpose of this Guide Note, the term “hazardous substances” covers any material within, around, or near a property that may have a negative impact on its value. Accordingly, the principles discussed in this Guide Note apply equally to hazardous substances that may be contained within the property and external hazardous substances.

The purpose of this Guide Note is to provide guidance in the application of the Uniform Standards of Professional Appraisal Practice (USPAP) to the appraisal of real property affected by or potentially affected by hazardous substances and, in particular, to the consideration of such hazards in the appraisal process. It is not the purpose of this Guide Note to provide technical instructions or explanations concerning the detection or measurement of the effect of hazardous substances.

## **Competency**

The Competency Rule of the Uniform Standards of Professional Appraisal Practice requires the appraiser to either 1) properly identify the problem to be addressed and have the knowledge and experience necessary to complete the assignment competently or 2) disclose the appraiser’s lack of knowledge or experience to the client before accepting the assignment; take all steps necessary or appropriate to complete the assignment competently; and describe the lack of knowledge and/or experience and the steps taken to complete the assignment competently in the report.

The Competency Rule is of particular importance in the appraisal of real property that may be affected by hazardous substances. Most appraisers do not have the knowledge or experience required to detect the presence of hazardous substances or to measure the quantities of such material. The appraiser, like the buyers and sellers in the open market, typically relies on the advice of others in matters that require special expertise.

There is nothing to prevent a professional appraiser from becoming an expert in other fields, but the real estate appraiser is neither required, nor expected, to be an expert in the special field of the detection and measurement of hazardous substances. This Guide Note therefore addresses the problem of hazardous substances from the viewpoint of the appraiser who is not qualified to detect or measure the quantities of hazardous substances. If an appraiser is qualified to detect or measure hazardous substances, a different standard would apply.

In appraisal assignments in which the appraised value is to take into account the effects on value of hazardous substances, most appraisers require the professional assistance of others. In appraisal assignments in which the appraised value *does not* take into account the possible effects on value of known hazardous substances, the appraiser would not require the professional assistance of others. These alternatives are further discussed below.

The appraiser may accept an assignment involving the consideration of hazardous substances without having the required knowledge and experience in this special field, provided the appraiser discloses such lack of knowledge and experience to the client prior to acceptance of the assignment, arranges to complete the assignment competently, and describes the lack of knowledge or experience and the steps taken to competently complete the assignment in the report. This may require association with others who possess the required knowledge and experience or reliance on professional reports prepared by others who are reasonably believed to have the necessary knowledge and experience. If the appraiser draws conclusions based upon the advice or findings of others, the appraiser must believe that the advice or findings are made by persons who are properly qualified. (See Guide Note 4, Reliance on Reports Prepared by Others.) It is suggested that the client, not the appraiser, choose and hire any qualified environmental professionals.

In some cases, an appraiser may be asked to complete a checklist which lists specific contaminants and questions the appraiser's knowledge of each. This is addressed in USPAP Advisory Opinion AO-9 entitled "Responsibility of Appraisers Concerning Toxic or Hazardous Substance Contamination," which states, "If an appraiser is requested to complete a checklist as part of the process for recognizing contamination, the appraiser should only respond to those questions that can be answered competently by the appraiser within the limits of his or her particular expertise in this area."

### **Scope of Work**

S.R. 1-2(f) requires that, in any assignment, the appraiser establish the appropriate scope of work necessary to complete that assignment. Part of the scope-of-work decision includes how, and to what extent, the appraisal problem will address known or suspected hazardous materials that may impact the property. The Comment to S.R. 1-2(f) states:

Comment: The scope of work is acceptable when it is consistent with:

- the expectations of participants in the market for the same or similar appraisal services; and
- what the appraiser's peers' actions would be in performing the same or a similar assignment in compliance with USPAP.

An appraiser must have sound reasons in support of the scope-of-work decision, and must be prepared to support the decision to exclude any information or procedure that would appear to be relevant to the client, an intended user, or the appraiser's peers in the same or a similar assignment.

An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal.

S.R. 2-2(a)(vii), 2-2(b)(vii), and 2-2(c)(vii) require that the scope of work be disclosed in the appraisal report.

Depending on the intended use, the appraisal may be prepared so that the value opinion reflects no known or suspected hazardous materials that may impact the property, or it may be prepared so that the value opinion *does* reflect known hazardous substances. In either case, the appraiser must take special precautions in the development and reporting process to ensure that the results of the assignment are credible and that the report is not misleading.

Because the appraiser's value opinion is based on assessment of what a knowledgeable buyer would pay a knowledgeable seller, the appraiser needs to be aware of the steps that knowledgeable buyers and sellers now take in the marketplace. Under federal and most state laws, the owner of a piece of property which is contaminated, and from which there is a release or threatened release, may be held liable for the cost of corrective action. Under federal and state laws, an "innocent purchaser" may avoid this liability. In order for a purchaser to qualify for the "innocent purchaser" defense, the purchaser must establish that it undertook all proper investigation of the property and the investigation indicated that the property was clean. This has come to mean, at a minimum, that the purchaser of commercial, industrial, or vacant property must conduct at least a "Phase I" investigation of the property prior to acquisition. Such an investigation entails a review of the property, its history, and available government records to determine if there is reason to believe that it may contain contamination. If a properly conducted Phase I investigation finds no likelihood of contamination, it should be sufficient to establish the "innocent purchaser" defense. If the potential for contamination is disclosed in the Phase I report, further investigation, often characterized as Phase II or Phase III investigation, should be able to determine with a reasonable degree of scientific certainty whether the property is affected by contamination, and if it is, what the possible remedies and costs may be. Given the accepted practice in the marketplace, the appraiser may wish to qualify his or her appraisal as follows:

If the appraiser has been provided with a Phase I, Phase II, or Phase III report finding no evidence of possible contamination:

The client has provided an environmental assessment for the property performed by XXX. According to the report describing that assessment, dated XXX, no adverse hazardous substances were found on the subject property. The reader of this appraisal report is urged to review the entire environmental assessment for specific detail.

If no Phase I report has been prepared or provided to the appraiser and the appraiser has no reason to suspect the existence of hazardous substances, the appraiser may wish to state specifically that:

The appraiser has not reviewed a Phase I report of examination and such an examination is customary in the transfer of commercial, industrial, or vacant real estate. The appraisal is based on an assumption of a Phase I report indicating no contamination.

### **Assignments Involving NO Known or Suspected Hazardous Substances**

When there are no known or suspected hazardous substances associated with the property, it is recommended, as a matter of standard practice, that the appraiser issue a disclaimer or limiting condition to the effect that the appraisal is predicated on the assumption that hazardous substances do not exist. An example of such a disclaimer might be as follows:

Unless otherwise stated in this report, the existence of hazardous substances, including without limitation asbestos, polychlorinated biphenyl, petroleum leakage, or agricultural chemicals, which may or may not be present on the property, was not called to the attention of nor did the appraiser become aware of such during the appraiser's inspection. The appraiser has no knowledge of the existence of such materials on or in the property unless otherwise stated. The appraiser, however, is not qualified to test for such substances. The presence of such hazardous substances may affect the value of the property. The value opinion developed herein is predicated on the assumption that no such hazardous substances exist on or in the property or in such proximity thereto, which would cause a loss in value. No responsibility is assumed for any such hazardous substances, nor for any expertise or knowledge required to discover them.

### **Assignments Involving SUSPECTED Hazardous Substances**

If in the course of completing an appraisal assignment, the appraiser discovers reason to believe there *may* be hazardous substances associated with the property, the appraiser should immediately notify the client to address the situation. The appraisal may be completed based on the *extraordinary assumption* that there are no hazardous substances affecting the property's value. However, the client may at this time wish to investigate further by requesting the services of an environmental professional before the appraisal is completed.

USPAP defines an “extraordinary assumption” as “an assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser’s opinions or conclusions.” The Comment to this definition states: “Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.”

Standards Rule 1-2(g) requires that in developing an opinion of value the appraiser identify “any extraordinary assumptions necessary in the assignment.” The Comment states:

An extraordinary assumption may be used in an assignment only if:

- it is required to properly develop credible opinions and conclusions;
- the appraiser has a reasonable basis for the extraordinary assumption;
- use of the assumption results in a credible analysis; and
- the appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.

Standards Rules 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii) require the appraiser to state in the appraisal report all extraordinary assumptions upon which the value opinion is premised. Any extraordinary assumption must be disclosed in conjunction with statements of each opinion or conclusion that was affected. Therefore, if the value conclusion is presented in several places within the appraisal report, the extraordinary assumption must be repeated, or a clear reference to it must be made, each time.

Standards Rule 2-1 requires the report to “clearly and accurately disclose any ... extraordinary assumption ... that directly affects the appraisal and indicate its impact on value.” This Standards Rule does not require that the appraiser quantify the impact on value, such as by both valuing the property subject to the extraordinary assumption and valuing it not subject to the extraordinary assumption. A brief discussion of the likely impact on value is all that is required.

An example of the disclosure of such an extraordinary assumption would be as follows:

During the course of completing this assignment, the appraiser became aware that [give reason for suspecting the presence of hazardous substances]. Unless otherwise stated in this report, the existence of hazardous substances, including without limitation asbestos, polychlorinated biphenyl, petroleum leakage, or agricultural chemicals, which may or may not be present on the property, was not called to the attention of nor did the appraiser become aware of such during the appraiser’s inspection. The appraiser is not qualified to test for such substances. The presence of such hazardous substances may affect the value of the property. The value opinion developed herein is predicated on the extraordinary assumption that no such hazardous substances exist on or in the property or in such proximity thereto which would cause a loss in value. No responsibility is assumed for any such hazardous substances, nor for any expertise or knowledge required to discover them.

The foregoing disclosure may be placed in the letter of transmittal, scope-of-work section, or general comment section, depending on the type and length of report prepared. In an oral report, the appraiser should present the same information, if possible.

Further, as discussed above, the extraordinary assumption must be mentioned every time the value opinion that is affected by it is presented in the report. For example:

The appraiser's final opinion of the market value of the subject property as of January 1, 2XXX, is therefore \$XXX,XXX. This opinion is made based on the extraordinary assumption that the subject property is unaffected by hazardous substances.

**Assignments Involving KNOWN Hazardous Substances:  
Appraised Value DOES NOT Account for Their Effect**

If a property is known to be affected by hazardous substances, it may serve a valid and useful purpose to develop a value opinion for the property that excludes the consideration of known hazardous substances. Such an appraisal would be based on a hypothetical condition; i.e., that the property is not impacted by known hazardous substances. Such an appraisal could be required as the logical starting point in a study of the impact of hazardous substances or in connection with legal proceedings.

USPAP defines a "hypothetical condition" as "that which is contrary to what exists, but is supposed for the purpose of analysis." The Comment states: "Hypothetical conditions assume conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in the analysis."

Standards Rule 1-2(h) requires that in developing an opinion of value the appraiser identify "any hypothetical conditions necessary in the assignment." The Comment states:

A hypothetical condition may be used in an assignment only if:

- use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;
- use of the hypothetical condition results in a credible analysis; and
- the appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions.

Standards Rules 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii) require the appraiser to state in the appraisal report all hypothetical conditions upon which the value opinion is premised. Any hypothetical condition must be disclosed in conjunction with statements of each opinion or conclusion that was affected. Therefore, if the value conclusion is presented in several places within the appraisal report, the hypothetical condition must be repeated, or a clear reference to it must be made, each time.

Standards Rule 2-1 requires the report to “clearly and accurately disclose any ... hypothetical condition ... that directly affects the appraisal and indicate its impact on value.” This Standards Rule does not require that the appraiser quantify the impact on value, such as by both valuing the property subject to the hypothetical condition and valuing it not subject to the hypothetical condition. A brief discussion of the likely impact on value is all that is required.

An example of the disclosure of such a hypothetical condition would be as follows:

It is reported that asbestos is present within the subject property. In accordance with the client’s instructions and consistent with the intended use of this appraisal, the value opinion is based on the hypothetical condition that the subject property is not impacted by asbestos. The presence of asbestos may have a negative influence on the value of the subject property, but the consideration of the effects of asbestos on the value of the subject property is beyond the scope of this assignment. The appraiser cautions against the use of this appraisal for any use other than the intended use stated herein.

The foregoing disclosure may be placed in the letter of transmittal, scope-of-work section, or general comments section, depending on the type and length of report prepared. In an oral report, the appraiser should present the same information, if possible.

In addition to the foregoing, the hypothetical condition should be stated with any statement of the purpose of the appraisal. For example:

The purpose of this appraisal is to develop an opinion of the market value of the subject property, based on the hypothetical condition that it is unaffected by asbestos, as of January 1, 2XXX.

Further, as discussed above, the hypothetical condition must be mentioned every time the value opinion that is affected by it is presented in the report. For example:

The appraiser’s final opinion of the market value of the subject property as of January 1, 2XXX, is therefore \$XXX,XXX. This opinion is made based on the hypothetical condition that the subject property is unaffected by asbestos.

If the appraiser is provided with a Phase I, Phase II, or Phase III report that indicates the possibility of contamination, that must be noted together with the amount of further investigation that is required by customary business practice as well as necessary to establish the “innocent purchaser” defense (such further investigation must reveal the absence of contamination to establish the “innocent purchaser” defense). A statement similar to the following is suggested:

The client has provided a Phase XX environmental assessment for the property performed by XXXX. According to the report describing that assessment, dated XXX, the following hazardous substances are found on the subject property. The reader of this appraisal report is urged to review the entire environmental assessment for specific detail.

### **Assignments Involving KNOWN Hazardous Substances: Appraised Value Accounts for Their Effect**

In developing an appraisal based in part on the findings of others with respect to the existence and effects of known hazardous substances, the appraiser must correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal. The loss of value attributable to hazardous substances is sometimes measurable using the same methods and techniques that are used to measure depreciation from other causes. In other cases, more specialized techniques are indicated. However, in some cases even environmental professionals cannot agree on the level of clean-up required, the appropriate method of that clean-up, or the cost of clean-up.

The appraiser is cautioned that the value of a property impacted by hazardous substances may not be measurable simply by deducting the typical remediation cost, or discovery cost from the total value, as if “clean.” The possibility of other changes affecting value, such as a change in highest and best use, marketability, and stigma, should be considered. In any analysis the appraiser should concentrate on developing an opinion of the hazardous substances’ effect on value.

### **Summary of Standard Practices**

1. Disclose to the client the appraiser’s lack of knowledge and experience with respect to the detection and measurement of hazardous substances (Competency Rule).
2. Take the necessary steps to complete the assignment competently such as personal study by the appraiser, association with another appraiser who has the required knowledge and experience, or obtaining the professional assistance of others who possess the required knowledge and experience (Competency Rule).
3. Identify in the appraisal process and state in the report if the appraisal is based on an extraordinary assumption or hypothetical condition that the property is appraised as if unaffected by hazardous substances (S.R. 1-2(h), S.R. 2-1(c), and S.R. 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii)).
4. Identify in the appraisal process any known hazardous substances affecting the property (S.R. 1-2(e)(i)).
5. Identify the scope of work necessary to complete the assignment, including the manner and degree to which hazardous substances will be addressed (S.R. 1-2(e)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

## Consideration of the Americans with Disabilities Act in the Appraisal Process

### **Introduction**

The Americans with Disabilities Act of 1990 became effective as to the removal of barriers to entry and use by disabled persons in existing public accommodations as of January 26, 1992. It applies to alterations of existing public accommodations or commercial facilities as of the same effective date and new construction of commercial facilities or places of public accommodation designed for first occupancy after January 26, 1993.

In appraisals involving real estate that is covered by the Act, appraisers should address the question of whether or not the requirements of the Act could have an effect on the value opinion.

The need to comply with the Accessibility Guidelines set forth in the Regulations for existing facilities where compliance is readily achievable and on alterations or new facilities may be a substantial expense to be paid by the tenant or owner. This, in turn, can have an impact on the value of the property.

### **Competency**

The Competency Rule of the Uniform Standards of Professional Appraisal Practice requires the appraiser to either 1) properly identify the problem to be addressed and have the knowledge and experience necessary to complete the assignment competently or 2) disclose the appraiser's lack of knowledge or experience to the client before accepting the assignment; take all steps necessary or appropriate to complete the assignment competently; and describe the lack of knowledge and/or experience and the steps taken to complete the assignment competently in the report.

The Competency Rule is of particular importance in the appraisal of real property that comes under the provisions of the ADA Regulations. The typical appraiser does not have the knowledge or experience required to determine whether physical changes have to be made to existing facilities to conform to the ADA Regulations or whether alterations or new construction meets the requirements. The appraiser in most cases will have to rely on those with special expertise.

An appraiser is not prevented from developing expertise in the area of ADA requirements, but a real estate appraiser is not required to become an expert in the field of ADA requirements. This Guide Note addresses the area of ADA requirements from the viewpoint of the real estate appraiser who is not an expert in this area.

An appraiser may accept an assignment involving the considerations of ADA requirements without the required knowledge and experience in this area provided the appraiser discloses such lack of knowledge and experience to the client prior to acceptance of the assignment and arranges to complete the assignment competently. This may require association with others who possess the required knowledge and experience or reliance on professional reports prepared by others who are reasonably believed to have the necessary knowledge and experience. If the appraiser relies on the advice or findings of others, the appraiser must believe that the advice or findings are made by persons who are properly qualified. (See Guide Note 4, Reliance on Reports Prepared by Others.) It is suggested that the client hire qualified ADA experts.

In addition to an appropriate limiting condition, there should be an appropriate statement of purpose, and the conclusion should be properly qualified, as illustrated below.

The purpose of this appraisal is to develop an opinion of the market value of the subject property, as if unaffected by the elevator requirements of the ADA Regulations, as of July 1, XXXX.

### **Scope of Work**

S.R. 1-2(f) requires that, in any assignment, the appraiser establish the appropriate scope of work necessary to complete that assignment. Part of the scope-of-work decision includes how, and to what extent, the appraisal problem will address how compliance or lack of compliance with the ADA might impact the property. The Comment to S.R. 1-2(f) states:

The scope of work is acceptable when it is consistent with:

- the expectations of participants in the market for the same or similar appraisal services; and
- what the appraiser's peers' actions would be in performing the same or a similar assignment in compliance with USPAP.

An appraiser must have sound reasons in support of the scope-of-work decision, and must be prepared to support the decision to exclude any information or procedure that would appear to be relevant to the client, an intended user, or the appraiser's peers in the same or a similar assignment.

An appraiser must not allow assignment conditions or other factors to limit the extent of research or analysis to such a degree that the resulting opinions and conclusions developed in an assignment are not credible in the context of the intended use of the appraisal.

S.R. 2-2(a)(vii), 2-2(b)(vii), and 2-2(c)(vii) require that the scope of work be disclosed in the appraisal report.

Depending on the intended use, the appraisal may be prepared so that the value opinion reflects no known lack of compliance with ADA requirements, or it may be prepared so that the value opinion *does* reflect lack of compliance. In either case, the appraiser must take special precautions in the development and reporting process to ensure that the results of the assignment are credible and that the report is not misleading.

### **Assignments Involving NO Known or Suspected Lack of Compliance with ADA**

When there is no known or suspected lack of compliance with the ADA, it is recommended, as a matter of standard practice, that the appraiser include a general assumption in the appraisal report to the effect that the appraisal is predicated on the assumption that readily achievable barrier removals do not exist. Since the law is written on the basis that the final determination of whether or not readily achievable changes have been made will be determined by the courts, it can never be assumed that any property has met all the requirements.

The following example is offered for illustration only.

The Americans with Disabilities Act (ADA) became effective January 26, 1992. The appraiser has not made a specific compliance survey and analysis of this property to determine whether or not it is in conformity with the various detailed requirements of the ADA. It is possible that a compliance survey of the property together with a detailed analysis of the requirements of the ADA could reveal that the property is not in compliance with one or more of the requirements of the Act. If so, this fact could have a negative effect upon the value of the property. Since the appraiser has no direct evidence relating to this issue, possible noncompliance with the requirements of ADA was not considered in developing an opinion of the value of the property.

### **Assignments Involving SUSPECTED Lack of Compliance with ADA**

If in the course of completing an appraisal assignment the appraiser becomes aware of information indicating the property *may* lack compliance with the ADA, the appraiser should immediately notify the client of the situation. The appraisal may be completed based on the *extraordinary assumption* that there is no lack of compliance with the ADA that might affect the property's value. However, the client may at this time wish to investigate further by requesting the services of an ADA expert before the appraisal is completed.

USPAP defines an "extraordinary assumption" as "an assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser's opinions or conclusions." The Comment states: "Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis."

Standards Rule 1-2(g) requires that in developing an opinion of value the appraiser identify "any extraordinary assumption necessary in the assignment." The Comment states:

An extraordinary assumption may be used in an assignment only if:

- it is required to properly develop credible opinions and conclusions;
- the appraiser has a reasonable basis for the extraordinary assumption;
- use of the assumption results in a credible analysis; and
- the appraiser complies with the disclosure requirements set forth in USPAP for extraordinary assumptions.

Standards Rules 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii) require the appraiser to state in the appraisal report all extraordinary assumptions upon which the value opinion is premised. Any extraordinary assumption must be disclosed in conjunction with statements of each opinion or conclusion that was affected. Therefore, if the value conclusion is presented in several places within the appraisal report, the extraordinary assumption must be repeated, or a clear reference to it must be made, each time.

Standards Rule 2-1 requires the report to “clearly and accurately disclose any extraordinary assumption ... that directly affects the appraisal and indicate its impact on value.” This Standards Rule does not require that the appraiser quantify the impact on value, such as by both valuing the property subject to the extraordinary assumption and valuing it not subject to the extraordinary assumption. A brief discussion of the likely impact on value is all that is required.

An example of the disclosure of such an extraordinary assumption would be as follows:

During the course of completing this assignment, the appraiser became aware that [give reason for suspecting the lack of ADA compliance]. The Americans with Disabilities Act (ADA) became effective January 26, 1992. The appraiser has not made a specific compliance survey and analysis of this property to determine whether or not it is in conformity with the various detailed requirements of the ADA. It is possible that a compliance survey of the property together with a detailed analysis of the requirements of the ADA could reveal that the property is not in compliance with one or more of the requirements of the Act. If so, this fact could have a negative effect upon the value of the property. Since the appraiser has no direct evidence relating to this issue, this appraisal was made based on the extraordinary assumption that the property is not impacted by lack of compliance with the ADA.

The foregoing disclosure may be placed in the letter of transmittal, scope-of-work section, or general comment section, depending on the type and length of report prepared. In an oral report, the appraiser should present the same information, if possible.

Further, as discussed above, the extraordinary assumption must be mentioned every time the value opinion that is affected by it is presented in the report. For example:

The appraiser’s final opinion of the market value of the subject property as of January 1, 2XXX, is therefore \$XXX,XXX. This opinion is made based on the extraordinary assumption that the subject property is not impacted by lack of compliance with the Americans with Disabilities Act.

**Assignments Involving KNOWN Lack of ADA Compliance:  
Appraised Value DOES NOT Account for Its Impact**

If a property is known to be out of compliance with the ADA Regulations, it may serve a valid or useful purpose to appraise the property as though ADA compliance were not at issue. Such an appraisal could be required as the logical starting point in a study of the impact of the ADA Regulations. Whatever the purpose, such an appraisal must be properly qualified to prevent its misuse. The valuation of property that has known readily achievable changes required to meet the ADA Regulations would be based on the *hypothetical condition* that the property is not impacted by lack of ADA compliance.

USPAP defines a “hypothetical condition” as “that which is contrary to what exists, but is supposed for the purpose of analysis.” The Comment to this definition states: “Hypothetical conditions assume conditions contrary to known facts about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.”

Standards Rule 1-2(h) requires that in developing an opinion of value the appraiser identify “any hypothetical conditions necessary in the assignment.” The Comment states:

A hypothetical condition may be used in an assignment only if:

- use of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison;
- use of the hypothetical condition results in a credible analysis; and
- the appraiser complies with the disclosure requirements set forth in USPAP for hypothetical conditions.

Standards Rules 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii) require the appraiser to state in the appraisal report all hypothetical conditions upon which the value opinion is premised. Any hypothetical condition must be disclosed in conjunction with statements of each opinion or conclusion that was affected. Therefore, if the value conclusion is presented in several places within the appraisal report, the hypothetical condition must be repeated, or a clear reference to it must be made, each time.

Standards Rule 2-1 requires the report to “clearly and accurately disclose any ... hypothetical condition ... that directly affects the appraisal and indicate its impact on value.” This Standards Rule does not require that the appraiser quantify the impact on value, such as by valuing the property both subject to the hypothetical condition and valuing it not subject to the hypothetical condition. A brief discussion of the likely impact on value is all that is required.

An example of the disclosure of such a hypothetical condition would be as follows:

In accordance with the client's instructions, and consistent with the intended use of the appraisal, the opinion of value is based on the hypothetical condition that the subject property is unaffected by the elevator requirements of ADA. It is known that the elevators do not meet the requirements of ADA and if they are required to be brought in line with the Regulation it would have a negative effect on the value of the subject property. The consideration of the negative effect on value that would occur if the elevators are required to be brought into compliance is beyond the scope of this assignment. The appraiser cautions against the use of this appraisal for any use other than the intended use stated herein.

The foregoing disclosure may be placed in the letter of transmittal, scope-of-work section, or general comments section, depending on the type and length of report prepared. In an oral report, the appraiser should present the same information, if possible.

In addition, the hypothetical condition should be stated with any statement of the purpose of the appraisal. For example:

The purpose of this appraisal is to develop an opinion of the market value of the subject property, as if unaffected by the elevator requirements of the ADA Regulations, as of July 1, 2XXX.

Further, as discussed above, the hypothetical condition must be mentioned every time the value opinion that is affected by it is presented in the report. For example:

The appraiser's final opinion of the market value of the subject property as of July 1, 2XXX is therefore \$XXX, XXX. This opinion is made based on the hypothetical condition that the subject property is unaffected by the elevator requirements of the ADA Regulations.

**Assignments Involving KNOWN Lack of ADA Compliance:  
Appraised Value Accounts for Its Impact**

In developing an appraisal based in part on the findings of others with respect to changes that are required to meet the ADA Regulations, the appraiser must correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal. The loss of value attributable to required changes is generally measurable using the same methods and techniques that are used to measure curable depreciation from other causes. However, it must be recognized that experts will disagree on what are readily achievable barrier removals.

The appraiser is cautioned that the value of a property which has physical barriers to the disabled may not be measurable simply by deducting the cost to cure from the value opinion developed before the required changes. The possibility of using auxiliary aids, changing the use of the property so it is not a public accommodation, or making the changes over time should be considered.

### **Summary of Standard Practices**

1. Disclose to the client the appraiser's lack of knowledge and experience with the ADA Regulations and their requirements (Competency Rule).
2. Take the necessary steps to complete the assignment competently, such as personal study by the appraiser, association with another appraiser who has the required knowledge and experience, or obtaining the professional assistance of others who possess the required knowledge and experience (Competency Rule).
3. Identify in the appraisal process and state in the report if the appraisal is based on an extraordinary assumption or hypothetical condition that the property is appraised as if unaffected by ADA requirements (S.R. 1-2(h), S.R. 2-1(c), and S.R. 2-2(a)(viii), 2-2(b)(viii), and 2-2(c)(viii)).
4. Identify in the appraisal process any known lack of ADA compliance (S.R. 1-2(e)(i)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

## Use and Applicability of Letters of Transmittal

### Introduction

A letter of transmittal means any type of written letter, memorandum, or statement that serves as a notice of delivery from the appraiser to a second party of a report containing an opinion or conclusion concerning real estate. The letter of transmittal may be a part of the appraisal report, or it may be a separate document.

The Uniform Standards of Professional Appraisal Practice do not require the use of a letter of transmittal. In many cases, such as with brief form reports, a letter of transmittal is not practical. With a few exceptions, USPAP is silent with regard to the use, or nonuse, of a letter of transmittal. The Management section of the Ethics Rule addresses "... fees, commissions, or things of value connected to the procurement of an appraisal, appraisal review, or appraisal consulting assignment" and requires that disclosure of such fees, if any, "...should appear in the certification of a written report and in any transmittal letter in which conclusions are stated." The Standards Rules that require a signed certification to be included in the report (S.R. 2-3, 3-2, 5-3, 8-3, and 10-3) mention that any appraiser who signs a letter of transmittal (if one is used) must also sign a certification.

When used appropriately, a letter of transmittal is a good business practice. Used inappropriately, the letter of transmittal may inadvertently cause the appraiser to be in violation of USPAP.

The letter of transmittal can serve the following purposes:

1. It is a communication between the appraiser and the client, identifying the client who authorized the appraisal and establishing the fact that the appraiser has completed his or her contractual obligation in compliance with a previous contract, agreement, or letter of engagement.
2. It confirms the business and/or fiduciary relationship agreement between the client and the appraiser as to the work product embodied in the assignment and may enable the appraiser to limit the widening of that relationship to unintended users.
3. It may call attention to unusual conditions of the engagement, hypothetical conditions, extraordinary assumptions, or unusual limiting conditions that affect the assignment.
4. It may be used to establish the client as the party ordering the report and responsible for payment of the associated fee, while putting the client on notice that certain limitations (such as the right of publication and the possibility of submitting the report to a peer review committee) apply.
5. It may disclose the scope of work applied in the assignment, and any permitted departures from Standard 1, so that the client and intended users of the report understand the inherent level of reliability.

6. It may state the report option used and, in a Restricted Use Appraisal Report, may contain the use restriction required by Standards Rule 2-2(c) that limits reliance on the report to the client.
7. It may, if the letter of transmittal is a part of the appraisal report, include the signed certification required by Standards Rule 2-3.

The letter of transmittal need not contain a statement of the value or other opinion(s) as set forth in the body of the report. If it does, however, the appraiser must try to ensure that the letter remains attached to the remainder of the report. If the letter of transmittal contains the appraiser's conclusion(s) and becomes detached from the body of the appraisal report, the letter could be used or construed as an appraisal report in itself. The reader of the letter could be misled or confused since the letter in itself will not typically meet the reporting requirements of USPAP.

If a Member signs the letter of transmittal, the Appraisal Institute will consider the report to have been "delivered" for purposes of enforcing E.R. 1-1(e), which provides:

It is unethical to knowingly contribute to or participate in the preparation or delivery of a report containing an appraisal, appraisal review, appraisal consulting, or real property consulting analysis, opinion, or conclusion that reasonable appraisers would not believe to be justified, whether or not such report is signed or delivered by the Member.

### **Basis for a Proper Letter of Transmittal**

The following is an example of a letter of transmittal which is considered to be consistent with the guidelines outlined in this Guide Note.

March 15, 2XXX

First Client Bank, Inc.  
1932 Atkinson Drive  
Chicago, Illinois

RE: The Hempstead Office Building, 2391 "A" Avenue, Greenville, Illinois  
Lot 23, Block 19, Glen Forest Office Park Subdivision, City of Greenville,  
Green County, Illinois

Dear [Mr. or Ms. Client]:

In fulfillment of the agreement outlined in the letter of engagement dated January 30, 2XXX, we are pleased to present the attached report of our appraisal of the leased fee estate in the referenced parcel of real estate, as of December 31, 2XXX. The report sets forth our opinion of market value along with supporting data and reasoning which form the basis of our opinion.

The value opinion reported is qualified by certain definitions, limiting conditions, and certifications which are set forth on pages 5 through 9 of this report. We particularly call to your attention to the extraordinary assumption set forth on page 8 dealing with the possible existence of hazardous or toxic materials on the premises appraised.

We also point out that the value developed is based on the hypothetical condition that the City of Greenville approved a Special Use Permit for the property as of the date of value. This hypothetical condition is addressed in detail on page 35 of the report.

This report was prepared for and our professional fee billed to First Client Bank, Inc. It is intended only for use by your internal management, your auditor, and appropriate regulatory authorities. It may not be distributed to or relied upon by other persons or entities without our written permission.

The property was inspected by John Evans, SRPA, and the appraisal was developed by Mr. Evans and Sally Briggs, MAI. If you have any questions concerning the report, please contact Ms. Briggs at (312) 555-7789.

Sincerely,

BROWN & BRIGGS

By: John J. Briggs, MAI, Managing Partner

To avoid potential for abuse, the letter of transmittal should be prepared in such a way that it cannot be mistaken for or misused itself as an appraisal report. It should be simply a statement of delivery and completion of an assignment. It would be a good practice for the appraiser to avoid summarizing the opinion(s) or conclusion(s) developed in the report, referring the reader, instead, to the body of the report itself. Thus, the reader or user of the report will see the opinion only in its proper context, with appropriate explanations, extraordinary assumptions, hypothetical conditions, limiting conditions, definitions, disclaimers, etc.

If the appraiser deems it appropriate to include the value opinion or other conclusion in the letter of transmittal, it should be qualified with a statement such as the following:

As a result of our analysis, we have formed an opinion that the market value (as defined in the Report), subject to the definitions, certifications, extraordinary assumptions, hypothetical conditions, and limiting conditions set forth in the attached Report, as of December 31, 2XXX, was:

ONE MILLION DOLLARS (\$1,000,000).

THIS LETTER MUST REMAIN ATTACHED TO THE REPORT, WHICH CONTAINS  
94 PAGES PLUS RELATED EXHIBITS, IN ORDER FOR THE VALUE OPINION SET  
FORTH TO BE CONSIDERED VALID.

### **Summary of Standard Practices**

1. If the value opinion is set forth in the letter of transmittal, include sufficient information in the letter so that it meets the reporting requirements for the appraisal report.
2. State any unusual circumstances associated with the assignment, such as unusual conditions of the engagement, extraordinary assumptions or hypothetical conditions used, or unusual limiting conditions.
3. Reference the appraisal report being transmitted, including its number of pages.

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)

# Use and Applicability of Engagement Letters

## Introduction

An engagement letter means a written or electronically transmitted agreement between the appraiser and the client setting forth the terms and conditions of an appraisal assignment. Neither the Uniform Standards of Professional Appraisal Practice nor the Code of Professional Ethics requires that engagement letters be used. However, use of an engagement letter is generally a sound business practice, as it serves to clarify the terms of the assignment and provides written evidence of the client's and appraiser's agreement to those terms.

## Basis for Appropriate Use

The engagement letter can be written by either the appraiser or the client, as long as both parties understand and agree to its entire content. In most cases the engagement letter should be drafted after the client and the appraiser have discussed the assignment and have orally agreed to the scope of the assignment, timing of completion by the appraiser, fee, and other parameters. The engagement letter then serves as an affirmation of this conversation.

If the appraiser and the client have an on-going relationship, the client (or trading partner) might initiate a new assignment by sending the appraiser (often via fax or electronic transmission) an *appraisal request* or *order form*. This procedure serves the same purpose as an engagement letter as long as it adequately addresses the requisite issues and the appraiser can agree to the terms of the assignment established by the client. Upon receipt it would be advisable for the appraiser to sign and date the request or otherwise document its acceptance.

The format and content of the engagement letter may vary depending on the nature of the assignment. Items that should be addressed include the following:

- Date of the engagement.
- Scope of work to be used in the assignment, including any agreed upon departures from the Standards Rules; if the Jurisdictional Exception applies, the applicable law or public policy should be referenced or a copy should accompany the engagement letter.
- Any supplemental standards (e.g., FNMA guidelines or FIRREA appraisal requirements) or special requirements of the client (e.g., photos, maps, data sheets, etc.).
- Reference to compliance with the Code of Professional Ethics & Standards of Professional of the Appraisal Institute (which include USPAP).
- Identification of the subject property.
- Identification of the interest to be valued.

- Intended use (function) of the appraisal.
- Intended user(s) of the appraisal.
- Purpose of the appraisal, i.e., value opinion(s) to be developed.
- Definition(s) of value opinion(s) to be developed.
- Number of copies of the appraisal report.
- Due date.
- To whom delivered and where, and method of delivery, if appropriate.
- Amount of agreed upon fee (and method of payment, if appropriate).
- Contact(s) for access to and information about the subject property.
- Client's name, company name, and phone number.
- Appraiser's name, company name, and phone number.

It is advisable for the engagement letter to be signed and dated by both the appraiser and the client, and both parties should retain a signed and dated copy. If it is not possible for both parties to sign and date the engagement letter, the appraiser should document its mutual acceptance.

When the terms and conditions of the assignment are set forth in a written engagement letter, any subsequent modifications to the original agreement should also be in writing (or transmitted in the same manner as the original engagement letter). The documented modifications should be retained with the original engagement letter by both the appraiser and the client.

If the engagement letter or appraisal request is transmitted electronically via a standard or proprietary transaction set, all necessary items must be addressed. If fields for the necessary information are not specifically provided, the information should be input as text.

### **Summary of Standard Practices**

1. Client requirements must be consistent with USPAP, unless the Jurisdictional Exception applies.
2. The agreed upon fee must not be contingent upon the outcome of a valuation.
3. The engagement letter must be consistent with any verbal agreement with the client regarding the assignment.

## **GUIDE NOTE 9**

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4. Subsequent modifications to a written engagement letter should be in writing or otherwise properly documented.
  
5. An electronically transmitted request must adequately address all pertinent items.

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)