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Assumptions, extraordinary assumptions, hypothetical conditions

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This isn't going to be as boring as you think it's going to be! Read on.

Despite the best efforts of the Appraisal Standards Board and AQB Certified USPAP Instructors, there is still pervasive misunderstanding with respect to what constitutes an assumption, an extraordinary assumption, and a hypothetical condition-essential disclosure tools for appraising. Here's a short attempt to clarify these concepts.

USPAP states that an assumption is "that which is taken to be true." USPAP then makes the distinction between an assumption and an extraordinary assumption.

Appraisal reports typically contain a section of "General Assumptions and Limiting Conditions." These are assumptions related to information that the appraiser cannot personally verify but must rely upon in order to produce a credible result. A typical general assumption is that "factual information received from others is reliable," or that "there are no hidden defects in the property or in the soil." These are considered general assumptions and limiting conditions because they tend to apply in most reports.

In narrative reports, these assumptions need not appear each time. In many cases, they do and they become, in essence, dreaded "boilerplate." For example, providing a general assumption for ADA compliance in a land appraisal: is that incongruous?

Many preprinted appraisal report forms come with a section of assumptions and limiting conditions that cannot be edited by the appraiser. This can be problematic for some assignments. An appraiser may need to augment the preprinted section in order to have control over critical assumptions and limiting conditions.

A limiting condition establishes boundaries on the reliability of the appraisal result. The adoption and disclosure of these limits is an essential part of appraisal practice since appraisers rely on factors beyond their control, expertise, or ability to discover efficiently. Limiting conditions and general assumptions tend to be lumped together making it difficult to distinguish between them.

The appraiser is ultimately responsible for the use and misuse of "general" limiting conditions and assumptions and to understand which ones, and why, are included in the report. Appraisers should pay special attention when an appraisal report may come under particular scrutiny, or when an assignment is out of the ordinary. Limiting conditions are not defined in USPAP.

An Extraordinary Assumption (EA) is "an assumption, directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser's opinions or conclusions." The crucial distinction is the direct, specific relation.

Further, 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."

This is a useful (and essential) tool in situations where uncertainty exists and when it is required to develop credible opinions and analyses. USPAP allows for the use of an EA with proper disclosure, which will be discussed.

An extraordinary assumption is necessary when reporting a prospective value, such as that associated with new construction. The assumption functions as a flag to the reader so that he or she understands that the event upon which the value is based has not yet taken place and that the value opinion is not a prediction of the future but a prospective value based on a current perspective. The use of this type of extraordinary assumption is essential for appraisals for financial institutions.

Hypothetical Conditions (HC). These assume something to be true that is false, i.e. contrary to what is known by the appraiser to exist as of the effective date of the appraisal. Use of a Hypothetical Condition has stricter requirements surrounding its use than an extraordinary assumption. The use of the hypothetical condition is "clearly required for legal purpose, for purposes of reasonable analysis, or for purposes of comparison," and that its use results in a credible analysis.

One of the more typical (and generally accepted) hypothetical conditions is appraising a proposed 1-4 unit construction as if it exists as of the inspection date when it clearly does not . Here the HC is used for "reasonable analysis."

Some 1-4 family appraisers are beginning to provide prospective values with an extraordinary assumption for new construction. The GSE forms allow for hypothetical conditions via checkboxes but providing extraordinary assumptions is more challenging. This form limitation is no doubt a reason for continuing to employ a hypothetical condition for new construction.

With regard to Hypothetical Conditions, if you are tempted to use them (and there are appropriate uses for them), make sure that they are not really extraordinary assumptions. Extraordinary assumptions convey uncertainty; Hypothetical Conditions make what is false true.

Both extraordinary assumptions and hypothetical conditions have two disclosure requirements. These are often not observed by appraisers, but need to be. These are: A) state all extraordinary assumptions and hypothetical conditions; B) state that their use might have affected the assignment results.

Note also that different appraisal practice areas look differently on the use of extraordindary assumptions and hypothetical conditions.

Proper use of limiting conditions, assumptions, extraordinary assumptions, and hypothetical conditions is a critical skill needed in today's complex markets and liability fraught appraisal environment. Proper development and disclosure provides necessary understanding of the limits and foundation of the appraisal for the appraiser and the reader. Take some time to think through these concepts and ensure they are being employed appropriately in your appraisal practice.

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