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Back to the basics of appraisals in 2024 - by Pastuszek

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William Pastuszek

There are times when the appraisal process needs to be reviewed and one's understanding of the foundational elements renewed. Given current markets, this is a particularly good time to do so.

The essence of appraisal is the benchmarking appraisers engage in by comparing the subject of the appraisal to similar properties. This method – called the Sales Comparison Approach or the Direct Sales Comparison Approach – is defined as the “process of deriving a value indication for the subject property by comparing sales of similar properties to the property being appraised, identifying appropriate units of comparison, and making adjustments to the sale prices (or unit prices, as appropriate) of the comparable properties based on relevant, market-derived elements of comparison” (Dictionary of Real Estate Appraisal).

The comparisons – otherwise known as “comps” – that are identified and utilized are key to producing accurate valuation, when the sales comparison approach is a primary valuation method. The applicability of the approach is based on the principle of substitution which “states that when several similar or commensurate commodities, goods, or services are available, the one with the lowest price will attract the greatest demand and widest distribution.” (Dictionary of Real Estate Appraisal) It needs to be said that all three approaches – cost, sales, income – depend in varying degrees on this fundamental economic principle.

Appraisers put enormous effort into locating comparable sales, rentals, and costs to support their value opinions. Locating and reporting the best comparable data is a great first step. But there's more to it than just great data.

The sales comparison approach is of fundamental significance in real estate valuation. The approach is applicable in one way or another for most property valuations.

Next step. When equally desirable properties are not exactly alike with the subject, the appraiser has to consider the differences between the subject property and the comparable properties and develop logical and supportable adjustment to account for these differences.

The process of making adjustments is underpinned by the principle of contribution. That principle is defined as follows “The amount a component of a property adds to the total value of the property. Contribution may or may not be equivalent to the cost to add the component.” (Dictionary of Real Estate Appraisal). We can also restate it as: “The concept that the value of a particular component is measured in terms of the amount it adds to the value of the whole property or as the amount that its absence would detract from the value of the whole.”

The integrity of the appraisal process depends on applying judgment in selecting appropriate comparable data and assigning rational and supportable adjustment quantities to account for differences between the subject and the comparables. Failure to support these selections and the adjustments results in faulty scope of work decisions. USPAP – Uniform Standards of Professional Appraisal Practice - utilizes the word “credible” to describe how to evaluate assignment results.

Credible is defined in USPAP as “worthy of belief.”

Ideally, adjustments are supported by quantitative analysis but when that type of data is not available, adjustments need support by relevant logic and analysis. Blind reliance on surveys or asserting something to be true without further analysis is no substitute for the critical thinking needed to provide credibility for adjustments made. It is equally important to address adjustments not made when they would seem necessary. In particular, market condition adjustments – or the lack thereof – need to consider conveying to the reader – in the appraisal report – as to why sales are adjusted negatively – for declining values – positively – for increasing values – or not all – for stable values. In the end, the report needs to reflect the appraiser’s thought process and provide the means to replicate the process adopted.

The current market challenges commercial real estate practitioners in terms of the availability of relevant market data and how to interpret it. Focusing on the basic principles and how they apply in carrying out an assignment and writing a report will enhance the impact on your clients. This is not the time to gloss over issues but a time to dig deeper and provide as much transparency in reporting as possible. More on feasibility, cost vs. value, and income streams in follow-up articles.

William Pastuszek, Jr., MAI, ASA, MRA heads up Shepherd Associates LLC, Needham, Mass.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540