

# Why an Appraisal?

Some helpful information from:

## *Gilliam Appraisal Services*

Appraisals are obtained for several reasons, including to:

### **To Settle an Estate**

- Taxing authorities such as the IRS often require appraisals to establish the value of an estate when a death occurs.
- Generally, the survivors want a conservative value estimate that limits their tax liability as much as possible.
- Most estate appraisals are ordered by attorneys, not by the survivors.

### **To Establish the Replacement Cost for Insurance**

Appraisals obtained for establishing the loss risk in case of fire, wind, earthquake, or other covered causes, are often limited to providing an estimate of the replacement or reproduction cost of the improvements.

- The insurable value may not be representative of market value and usually does not include the value of the land.
- Insurance agents may order appraisals when their standard cost service manuals are not adaptable to an atypical home or structure.
- Property owners may order appraisals to contest the annual appreciation increases mandated by some insurance companies, especially when the increase in the insurance coverage results in an unrealistic premium.

### **To Establish Just Compensation for Condemnation**

The appraiser may represent either the landowner or the condemning authority. Usually, the government entity that needs the land for public use orders an appraisal and offers to purchase the land for the value indicated by the appraisal.

If the landowner feels that the amount offered by the condemning authority is not enough, the landowner may also order an appraisal. Landowners often do not consider this option, though, they usually try to settle with the authority by negotiation rather than incur the expense of another appraisal.

It is obvious that the landowner's negotiating position would be enhanced if the landowner did order a professional appraisal report from an appraiser of their choice.

This appraisal report could be made available then to support the landowner's interest with the property's estimated value in an unbiased and professional manner.

If the parties still cannot agree on a price, then the matter will be settled in court with each appraiser testifying on behalf of their respective value estimates. Appraisers are not advocates for their client; they are expert witnesses trying to support their value estimates.

## **To Contest High Property Taxes**

If property owners feel that their property is assessed too high, then they may order an appraisal from a qualified appraiser to contest the assessment.

In certain parts of the country this practice is common, but many property owners are not aware that this avenue of reducing their tax burden is available.

The return on investment is easy to perceive when the cost of an appraisal is compared to several years of lower taxes for the property owner. Professional appraisers that accept these assignments must remember that sometimes they include an appearance in front of the equalization board to argue the landowner's case.

The appraiser, however, must be careful not to base the appraisal fee on the dollar amount of the appraised value, which could be a violation of the USPAP.

## **To Determine an Offering or Selling Price**

In the real world, very few individuals order appraisal reports to establish an offering price or to substantiate a purchase price. At the point that an offer to purchase (in a typical residential transaction) is made, the price has been set by other parties, not the purchaser. The price has been determined by:

1. the seller, who wishes to obtain the highest dollar possible. The seller is not expected to be objective about the property value, and every purchaser becomes a seller at some point in the future.
2. the agent, who receives a percentage of the price as compensation and often represents the seller in the transaction.

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

formal procedure in completing the CMA. If a seller wishes to list the property at a price higher than the price suggested by the agent, then the agent may be forced to accept the listing at that price or risk losing a commission. Listing agents, just like sellers, must protect their interests whenever feasible and legally possible.

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

So, is an appraisal important when considering making an offer on real estate? Is being armed with a reliable estimate of value a desirable position when purchasing a property?

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

- the property appraised for less than the sale price when appraised by the lender's or buyer's appraiser,
- the appraiser identified a problem that could have been solved before the sale, if the seller had known,
- the property will not qualify for the type of loan indicated on the contract, allowing the buyer to back out of the deal
- the property is listed too high, and remains on the market too long before selling.

## **To Obtain a Loan**

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

The majority of real estate appraisals are requested by lenders to establish the property's value for loan purposes. Except for periods of very low interest rates when everyone is refinancing, most loans are for the purchase of real estate; thus most appraisals are ordered after a sale price is negotiated. Purchasers assume that lenders are looking after their interests, but are they?

If the lender orders the appraisal, the appraiser is responsible only to the bank. The law requires that the lender order the appraisal, and the lender must be the client. We

expect lenders to be prudent and they should be, but being prudent is protecting their interest, not necessarily the purchaser's.

The lender's and the purchaser's position in a purchase transaction can be compared in this manner:

- **Lender:** has two sources of repayment: the purchaser's income and the property.
- **Purchaser:** is obligated to pay the note even if the property value declines to zero; because responsibility to repay the loan is not based upon the property's value.
- **Lender:** may have the loan insured or guaranteed by a government agency.
- **Purchaser:** does not have the promise of government to pay the purchaser's debt if property value is wrong.
- **Lender:** if loan is greater than 80% of the value, a portion of the loan may be insured by a private mortgage insurer.
- **Purchaser:** there is no decrease in risk, regardless of loan-to-value ratio. The investment by the purchaser is the same, a mixture of personal cash and a loan that must be repaid.
- **Lender:** rely on percentages as a hedge against losses and expect a certain amount of loss.
- **Purchaser:** individual does not have the ability to leverage by the percentages. The inability to pay for the property or repay just one real estate loan will be enough to create an insurmountable financial burden for most people.
- **Lender:** The lender is not required to have an appraisal by a qualified licensed or certified appraiser if the transaction amount (loan) is \$250,000 or less.
- **Purchaser:** unless financial picture is different than most, payment on a \$100,000 home is significant, not to mention the payment on a quarter of a million dollars (\$250,000).
- **Lender:** is using other people's money.
- **Purchaser:** is using personal funds, not someone else's.

So the lender can afford to be wrong several times, but can the purchaser afford to be wrong just one time? This is not to imply that there is something jaded about the lender's position; it is no more biased than our own.... but, the purchaser needs to be aware of the circumstances so that his or her position is protected.

## Summary

The cost of a residential appraisal is insignificant when compared to paying \$500, \$1,000 or \$10,000 more than the property's value. This is especially true in the current market where appreciation is much less than it has been in the past and the purchaser may not be able to recover the initial price when the property is sold.

The person who orders an appraisal often feels that the fee was wasted if the property appraises for the sale price or more but compare that circumstance to the purchase of insurance: If your home doesn't burn is the insurance premium wasted?

### **Why are the majority of appraisals obtained?**

Because.....

- a lender requires it
- a government agency such as the IRS requires it
- you are involved in a lawsuit

### **Why should an appraisal be obtained?**

To.....

1. lower your tax burden
2. help you make one of the largest financial decisions in your life
3. provide a negotiating tool when purchasing real estate
4. determine a reasonable price when selling real estate
5. protect your rights in a condemnation case
6. allow you to obtain a qualified appraisal report from a qualified appraiser.