

THE OPINION OF THE COLLEGE ON

Definitions, Concepts and Principles of Appraisal Practice

Initiation, Chair responsibility,
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- A. The word *property* is used in four different senses: (1) it may be used to mean physical object or thing, disregarding ownership; (2) it may be used to mean the legal rights encompassed in an ownership; (3) it may be used to mean the *thing* that is owned, tangible or intangible, or both; and (4) it may be used as a collective noun. An appraiser should distinguish between these four meanings and specify in what sense he or she is using the word.
- B. In making the kind of appraisal called a *valuation*, the subject property should first be classified as *investment property*, *marketable noninvestment property*, or *service property*. An investment property can be valued *only* by the Investment Analysis Method, a marketable noninvestment property can be valued *only* by the Sales Analysis Method, and a services and a service property (if it can be valued at all) can be valued *only* by the Cost Summation Method.
- C. The so-called "three approaches to value"—doctrine that requires that all three approaches be applied to any property, regardless of its characteristics, and then that the three results be "correlated" to reach a conclusion as to value—is economically unsound and produces unreliable results.
- D-1. An investment property has a value as an investment (investment value), that is generated by its earning expectancy. The investment value is its justifiable market value (as distinguished from the current price at which it might be sold) and it has an owner value that may or may not be the same as its investment market value.
- D-2. A marketable noninvestment property (a property without an earning expectancy but of a type commonly bought and sold) has a value generated by its expected uses and/or consumption. Such a property has a market value and an owner value, but this owner value may or may not be the same as the market value.
- E. In those cases in which a *whole* property comprises *components*, each of the components has a value when considered as a PART of the whole, which is different from its value when considered as a FRACTION (i.e., as separated from or independent of the whole).

- F. There is a body of appraisal principles on which is built the entire structure of appraisal methods and techniques. (A principle is "A fundamental truth, a primary or basic law, doctrine or the like.")

Appraisal Principles

1. *The Causal Postulate.* Quantitative appraisals are based on analysis of past experience expressed as numerical data: prices, costs, rents, expenses, sales and other revenues, salaries, wages, lives of physical entities, changes in population, etc. The Causal Postulate *assumes* that these numerical results were *caused*, even if the individual causes cannot be isolated. The causes may be some combination of supply and demand factors, managerial ability, sales ability, inventiveness, the possession of natural resources, political climate, and so forth.

2. *The Continuity Postulate.* In addition to assuming that the data of past experience are the effects of causes, it is further assumed that, whatever the causes were, if the same combination of causes occurs again, the effects will be the same as before. In appraisal practice, this idea is still further extended: it is *assumed* that, unless there is evidence that the interrelated causes that gave rise to the past effects have changed, the causes will continue and produce the same effects. This is the Continuity Postulate.

3. *Principle of Identification.* An appraisal to determine the authenticity of such a property as a painting, object of art, manuscript, or piece of antique furniture uses the *Principle of Identification*. A *genuine* article has certain identifying characteristics, traits, or marks. If the identifying characteristics of a genuine article match with the same characteristics of the subject property, the subject property is assumed to be the genuine.

4. *Principle of Qualitative Rating.* In those appraisals that render opinions of the condition, quality, attractiveness, or artistic merit of a subject property, the conclusions are derived by comparing the quality or characteristic of the subject property with which the appraisal is concerned with the same quality or characteristic as found in some other property or properties *used as a standard of comparison*. The principle involved states that the quality or characteristic with which the appraisal is to deal can be rated, ranked, or graded on a standard (non-numerical) scale such as, for example: Excellent, Good, Average, Fair, Poor; that is, the rating of the subject property in regard to this qualitative characteristic can be placed in one of these categories.

5. *Principle of Sampling.* It is assumed, when a sampling technique is used in an appraisal, that the selected sample of appraisal data is sufficiently representative of the totality of the relevant appraisal data to establish the validity of the appraisal conclusions within an estimated range of probability.

6. *Principle of Pricing.* Buyer's cost appraisals are concerned only with those kinds of property that are sold in identical units in an open market at advertised or published prices that are the same for all purchasers; excluded are unique properties that are sold at negotiated prices. The current market value of a marketable noninvestment property of this kind is equated to buyer's cost, which, in turn, is ascertained by pricing the article in open market. This is the Principle of Pricing.

7. *Principle of Generation of Property Value.* The value of a property is generated by the expectancy of future owner benefits.

8. *Principle of Cost Forecasting.* Cost forecasting is here distinguished from pricing; it is the method used in cost-summation appraisals. A cost-summation appraisal is an estimate of what it will cost to produce, demolish, alter, or repair a tangible property. The method consists of adding together all of the estimated individual items of cost. These are of two kinds: (1) items purchased in the open market, appraised at buyer's cost by the pricing principle; (2) items such as labor, supervision, indirect expense, financing, and so forth appraised on the basis of recorded data derived from past experience. These appraisals are forecasts of costs and rely on the causal and continuity postulates.

9. *Principle of Comparison as Used in Sales Analysis.* Marketable noninvestment properties that are not sold in identical units in an open market at advertised or published prices, but are unique and sold at *negotiated* prices, are valued by the Sales Analysis Method. This method is based on an analysis of the prices at which comparable properties have sold. The market value of the subject property is the most probable price that it would bring if offered for sale. A comparable property is one that has the same value elements as the subject property (but not necessarily, or even generally, in the same proportions). The Sales Analysis Method *assumes* that the price at which a comparable property sold was the result of the particular weighted combination of value elements comprising that property. The existence of the value elements, in certain proportions, is *assumed to be the cause* that produced the sales price as an *effect*. This is an example of the Causal Postulate. The amount that each value element contributes to the price is ascertained by analyzing a sufficient number of sales of comparable properties and correlating (mathematically) the numerical magnitudes of the value elements with the sales prices to give an equation, or "model." The numerical magnitudes of the value elements of the subject property are then inserted in the equation and its probable sale price calculated. There is another assumption here, namely that if the value elements were the causes of the sale prices of the comparable properties, these causes will have the same effects on the sale price of the subject property.

10. *Principle of Earnings—Forecasting.* In applying the Principle of the Generation of Property Value to an investment property, it is found that the expected future owner benefits are in the form of net monetary returns, either periodic income or capital gain or both. In order to value the property, it is necessary to forecast its earning expectancy. The past earning experience of the subject property and/or of comparable properties, adjusted for such trends and circumstances as can be foreseen as of the valuation date, is projected into the future. This forecasting is based on both the Causal Postulate and the Continuity Postulate.

11. *Principle of Present Worth of an Earning Expectancy.* The valuation of an investment property is based on the principle that, as of the valuation date, the value is *equivalent* to the series of future net returns. The present worth calculation is based on the principle that an investor, buying the subject property, expects (1) either to *preserve* the amount of his original investment or to *recover* the consumed portion thereof out of earnings and/or any terminal sale of assets and (2) to receive the equivalent of an annual remunerative yield on the unrecovered portion of his original investment; the yield rate being high enough to compensate him or her for the investment risk involved.