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Appraising: Residential Real Estate
Avoiding Valuation Pitfalls

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In Brief...
Ten common valuation traps affect appraisal accuracy. They can be avoided with a little care.

There are some topics that people just do not like to talk about. Appraisers most often avoid the subject of valuation mistakes. Making mistakes should be part of learning; unfortunately, the same mistakes recur because they are shrugged off or ignored.

How many times have we been ensnared by personal prejudices? How many times have we fallen for the decoys placed by transferees or real estate agents? How many times have we failed to see through the camouflage of cosmetics? How many times have we been caught off guard by subtle market changes or simply failed to learn from our mistakes?

Achieving excellence in relocation appraising means maintaining a variance between the appraised value and sales price of the home that is within the elusive but attainable 4 percent demanded by the industry. The 10 most common valuation traps are listed below to help improve appraisal accuracy.

1. Inadequate attention to buyer's point of view. One common mistake in relocation appraising is failure to understand market demand for the subject property. Some appraisers do not pay enough attention to competing listings, pending sales, and other supply and demand factors. Some fail to identify the likely buyer and examine his or her likely reaction to the market.

Appraisers devote most of their time and effort to the sales comparison approach. Many of us have a habit of rushing the appraisal process to call in a verbal within the three-day period, thereby failing to uncover, analyze, and verify all available pertinent market data.

Appraisers must pay the same careful attention to the competing listings and other supply and demand factors as they do their sales comparison analysis. There are consequences to putting the most weight on historical sales in a changing market and not understanding the subject's submarket and likely buyers' alternatives. Remember that the appraiser must anticipate the most likely actions of buyers under conditions of market uncertainty beyond the effective date of the appraisal.

2. Failure to forecast the market changes as they relate to the subject. The purpose of the relocation appraisal is to estimate the anticipated sales price, which is a prediction of a transaction yet to occur. Like forecasting the weather, forecasting appraised values appears very complex to many; there are, however, some basic concepts that can help (Forecasting is described here in a conceptual way. For a more detailed description of forecasting, call ERC on Demand™, 1-800/ERC-5952 and request document number 18501.).

Appraisal forecasting is like reading the clues to changing weather. Housing markets just do not change overnight. Appraisers who are surprised by a "sudden" change of market events have not been reading the clues sent out ahead. All sorts of real estate market information is there for the taking. It is simply a matter of knowing where to look to interpret market trends. If you wait for the "storm warnings" to be issued by the relocation management company, it will be too late!

Real estate market changes happen in three main stages, like those of a storm. If you can identify the stage, you can better tell what will come next. The knowledge that a storm is approaching will be a clue to watch for the formation. The first stage is the building stage. In the first stage of a storm, the clouds form, the winds kick up, and the wind direction may shift. You may hear thunder in the distance. Likewise, in this stage of residential real estate market forecasting, the appraiser must observe and track subtle market changes. Knowledge that a change is imminent is the lead time necessary for proper forecasting. If you have monitored the market continuously, you have taken the guess work out of a forecasting adjustment.

Michael A. Sklarz, Locations, Inc., and Norman G. Miller, University of Cincinnati, wrote in a paper that, "Market forces, which may be particularly important to local markets, will vary from area to area based on the local economic base. The key is to seek those variables that can provide as much lead time as possible with respect to real estate markets. In Detroit, auto inventories may be a better indicator than auto sales. The key is to seek those variables that can provide as much lead time as possible with respect to real estate markets. Indicators such as mortgage rates, sales activity, time on market, and inventory remaining have been successfully used to predict market price trends and turning points."

The following tendencies foretell a shift in the local residential real estate market. Conditions usually will be worse in residential submarkets when:

- **there are negative changes in employment/population.** Monitor the economic base. Are there known or projected conditions that would cause a deterioration to the local economy?
- **interest rates begin to inch upward.** Monitor interest rate movement. Are interest rates projected to increase, stabilize, or decrease during the projected marketing time?
- **the time on market in most price ranges is increasing.** Monitor multiple listing service data. Is the supply of available homes projected to increase or decrease?
- **the ratio of listings to sales is increasing.**
- **the expired or withdrawn listings are increasing beyond seasonal levels.**
- **building activity slows.** Monitor building permits and absorption rates. Is there strong competition from new homes with favorable rates?
- **it is taking longer to sell "spec" homes.**
- **the mood of buyers is changing.** Watch for a loss in confidence in certain price ranges and ask why they happened.
- **loan delinquencies and late payments are on the rise.**

You can customize the above list based on your economic base and local tendencies.

In the second stage of market forecasting, every appraiser in the territory knows that the market is declining and it is time to make a forecasting adjustment. But, the appraisals done last month still are on the market.

The market during the second stage is characterized by an oversupply of listings in most price ranges and declining property values. The slow mortgage repayments that were indicated in stage one now yield increased REO competition. New construction starts are at a standstill, and builders are offering concessions.

The third stage of forecasting answers when it will all be over. What comes next is easier to determine, as market conditions generally will stabilize and improve when:

- positive changes take place in employment;
- interest rates begin to decline;
- time on market in most price ranges is decreasing;
- the ratio of listings to sales is improving;
- expired listings are decreasing;
- building activity is increasing;
- "spec" homes are moving at an increasing rate; and
- the mood of buyers is improving.

The relocation appraiser who can identify the phases of his or her local market "storm" will be the most accurate. He or she knows that storms come in a variety of sizes and intensities and knows how to read the clues of a market that is stabilizing, leveling off, or declining.

Prepare for the prime relocation season during the slower months by collecting and reviewing all available data on supply and demand. Review the inventory by going through open houses and touring new listings. Use the listing sheets provided on each home to make notes on condition, decor, and other factors affecting marketability. Break down the inventory into submarkets or price ranges to understand what alternatives a buyer would have in each submarket. Attend meetings of the local economics club or other similar groups during the winter to keep abreast of local and state economic trends.

3. Being influenced by personal prejudices. The appraiser must always guard against the influence of his or her own personal prejudices. Personal prejudices can distort your view of the factors affecting value. Personal prejudices can creep into all areas of the appraisal process, from the initial inspection to the final reconciliation of value. We often hear "The standards must be set by the market and not by the appraiser," and "Final value must not be the product of the appraiser's imagination." It is risky to make decisions on the basis of personal impressions.

"The appraiser must ascertain what is sought and accepted by the typical buyer in the submarket that you are appraising. These standards vary over time as tastes, customs, and technology change. They also may vary from one segment of the market to another at the same time. Therefore, the appraiser must ascertain the standards of acceptability that are current and local in order to establish the criteria in terms of which the subject property is evaluated," wrote H. Grady Stebbins, MAI, in the Society of Real Estate Appraisers' "A Guide to Appraising Residences."

Examples of personal prejudices and judgmental bias in the appraisal process are hiding in many of our files--waiting there for us to discover. Go review your last five relocation appraisals that were off by more than 5 percent. Look at them objectively. Can you detect a pattern of bias? You may not be aware that you have a tendency toward personal prejudices and judgmental bias while you are performing the appraisal. As indicated above, buyers' likes and dislikes are extremely personal and changeable, as they are based on their needs and preferences. If appraisers stick rigidly to their attitudes about certain neighborhoods, home styles and designs, and decor, and based on these attitudes, make unsupported adjustments, they may find themselves wondering why their appraisals often are out of variance.

To eliminate bias, one must not lose sight of objectivity. Be more flexible, and allow the facts to form your appraisal decisions. The appraisal must be free of personal prejudices and judgmental bias, for the value conclusion should reflect the market evidence clearly stated.

4. and 5. Personalized and dated decor cover-up and underestimating the "as is" condition. These are two valuation traps that must be addressed together. It is easy to get caught up in the furnishings, personality, or lifestyle of the transferee. How many times have we underestimated the "as is" condition?

There are two common traps under "decor." The first is the failure to recognize and make adjustments for personalized decor. Have you seen custom decor that looked appropriate with the transferee's furniture at the time of inspection, and then when you went back wondered, "What new buyer will have furniture to fit with this?" The unaccounted cost to neutralize the decor could be enough to throw you out of variance.

The second trap is discovering too late that the adjustment you made for repairs or neutralization of the decor was not sufficient. It is not always easy to picture each room vacant. One solution is to use an interior detail room list that is organized so that you can proceed systematically through the home, recording detailed information for each room. Then, go back through the home a second time without the transferee to take pictures and measure rooms. You may be surprised at what you had missed the first time through; the chipped paint, scuff marks, stains, worn spots on floor covering, and dated wallpaper that did not appear the first time appear magically the second time you walk through the home. In the rush of relocation appraising, too much is being left to memory, with the result that important factors are not mentioned in the report.

On the next page are sample interior detail lists of two rooms. You can customize your own list for each room in the house.

The use of such an interior detail room list not only will help you recognize the two common decor traps, but also will help you to estimate the "as is" condition. Note that you can make comments on physical defects and functional inadequacies. A detailed room list of each room addresses interior decor, quality of components, features, and physical and functional inadequacies. Special features and personal property remaining also can be readily located. Taking the time to fill out these lists also will dispel any claims by the transferee that insufficient time was spent in the home and helps reduce call backs by the relocation company and appeals of values by transferees.

The cost of repairs and redecorating can be estimated accurately if you continually monitor those costs in your markets. Check with the relocation companies and real estate relocation departments to find out what costs were charged.

6. Inability to recognize relevant functional inadequacies. Recognizing relevant functional obsolescence in today's real estate market requires understanding buyers' preferences in the specific submarket and their specific needs based on competing alternatives. Functional inadequacies should be identified and then analyzed in the light of the particular submarket under consideration.

There are times when a buyer will ignore functional inadequacies because of affordability or limited alternatives. Many appraisers do not understand the needs of the targeted buyer in our changing, complex social structure and over or under adjust for functional inadequacies.

The best way to deal with functional inadequacies is to make a checklist of them as they relate to certain price ranges or submarkets. Ask yourself the following questions after reviewing factors of supply and demand.

- Do the features and amenities appeal to the target buyer for this price range? For example, in the upper price range, will the lack of a custom kitchen, three-car garage, fourth bedroom, or

whirlpool tub in the master bath cause buyer concern?
- Is the master bedroom adequate for this price range?
- Is the fireplace in the living room rather than in the family room?
- Are the second story bedrooms serviced by an upstairs bath?
- Are the subject's size and utility (floor plan) similar to those of other homes in the neighborhood?
- Are closets and storage adequate for this price range?
- Is the cost of utilities typical for its submarket? How will electric heat or inadequate insulation fare in the market?
- Does this home have a poor floor plan and layout? Does it lack a formal dining room, main floor laundry, or interior access to attached garage? Does the front door enter into an eating area?
- Does the home have a unique style (e.g., geodesic design)?

"The appraiser must identify the functional obsolescence, assess its impact on value, determine whether it's curable, and reflect these conclusions in the valuation," writes Frank K. Harrison, MAI, in "Appraising the Tough Ones."

7. Failure to recognize and adequately adjust for external inadequacies. Like functional obsolescence, the best way to deal with external (locational) obsolescence is to make a checklist and review it every time you do a transfer appraisal. A checklist acts as a reminder and helps identify those adverse external factors impacting marketability that may be missed during the rush of the assignment. Below is a list of some negative locational factors from outside the subject site that can adversely influence the sales price of the subject property:

- busy street or thoroughfare (heavy traffic);
- mixed land use in the immediate area, e.g., commercial, multifamily;
- power lines (perceived as negative);
- remote location away from major support facilities;
- noise or foul odors from industrial or special-use properties;
- contaminated land nearby; or
- backs to active railroad tracks.

The above are just a few external inadequacies that you may encounter. You can add to the list with external inadequacies common in your market.

8. Falling for the hype. How many times have you heard, "I have a buyer ready to sign at the full list price," "That foundation crack is of no concern to my buyer," or "That comparable sale was in inferior condition," only to find that you have fallen prey to willful misinformation? This slanting of opinion and shading of facts is common in the industry. Appraisers must learn when to distrust information from parties with an interest in the subject property, specifically, some sellers' agents. Most real estate salespeople are, however, willing to give their honest and objective opinion of listings and sales. Over time, you will learn which ones are reliable and knowledgeable.

Another common mistake is in not understanding the motivations of the seller or transferee and the policies of the companies in your area. Some employers reward transferees with a bonus if they sell their own home within a specified period. This may influence the seller to accept a lower price to achieve a quick sale and collect the bonus.

Appraisers also may make the mistake of bending to the good intentions of the transfer company coordinator. Have you ever increased or decreased your value because the transfer company said you were out of variance with the value of the appraiser and the broker's price opinion, only to find out that your original value was closer to the original sales price? If you have done your homework, stand firm on your original value and explain why you are doing so!

Beware, too, of a "trick of the trade" sometimes used by "seasoned" transferees (who have transferred four or five times) who will "fly speck" the lowest appraisal looking for weakness in the adjustment grid to have you increase your value. These transferees will attack your reputation for a few dollars. In most cases, an increase in value is not justified; however, your degree of vulnerability depends on how hastily and carelessly you handled the comparable sales.

Relocation appraising goes beyond understanding the actions of the typical buyer. A relocation appraiser must also understand the typical motivations of all the players involved in the relocation process.

9. Comparable sales thoughtlessly selected, hastily verified, and carelessly adjusted. In survey results presented by the National Association of Independent Fee Appraisers at its 1993 annual confrence, relocation company professionals complained that many appraisers use outdated comparables, comparables that are not truly comparable, and inconsistent adjustments. They say that appraisers do not inspect all comparables and they rely on the broker's description. According to the survey, many transfer companies believe brokers use better comparables! Appraisers need to demonstrate that this impression is false by preparing their reports thoroughly and clearly to show that they have, indeed, verified all data and assessed the comparability of the properties.

10. Lack of awareness. Your likely reaction is that lack of awareness is not a very common valuation trap when compared to the nine listed above! It does not seem to be an identifiable valuation trap measurable in terms of results. However, the first nine traps show the weakness of appraisers' awareness. There are two major common interrelating threads that run through eight of the nine previously mentioned valuation traps. The first most common thread is not focusing on the buyer's point of view. The second is lack of awareness.

To be aware is more than just knowing what is going on in your circle of activity. It means observing and being alert in drawing inferences from what one sees, hears, or learns in all facets of the appraisal industry. Relocation coordinators can cite numerous examples of poor awareness. The relocation coordinator receives incompatible appraisal reports and has to order the third appraisal, or has to call the appraisers back because of conflicting data.

These 10 most common valuation traps are presented here to freshen your view, heighten your awareness, and renew your interest in relocation appraising excellence. Do any of the 10 common valuation traps fit you? If they do, you are not alone!

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Living Room

		Cost to cure
Walls	Drywall with green floral wallpaper (dated)	$300
Ceiling	Drywall-white/ceiling fan (needs painting)	$200
Floors	Green plush carpet (average condition, dated)	$800
Trim	Stained pine-cuffed (needs restaining)	$150
Features	Brick-faced fireplace with oak mantel (loose)	$50
	Bay picture window (seal broken)	$50
Comments	Coat closet is in hallway and not convenient to 20 front door. No foyer; the front door enters 20 directly into the living room.	

Kitchen

		Cost to cure
Walls	Floral design wallpaper (dated)	$200
Ceiling	White/drywall average condition	-
Floor	Blue and orange design sheet vinyl (vivid/scuff marks)	$200
Cabinets	Original factory grade pine (inadequate storage)	--
Counters	White with gold fleck Formica (worn/dated/scratches)	$350
Appliances	Refridgerator: GE Almond/ice maker	--
	(1994) stays	--
	Range: GE wall oven/electric counter top	--
	Dishwasher: Maytag/almond (1994)	--
	Disposal: Insinkerator (1994)	--