Appraisal Institute of Canada
Institut canadien des évaluateurs

Professional Appraisers. Know the value.

WHAT IS THE REAL VALUE OF REAL PROPERTY?

Industry Guide to Understanding the Fundamentals of Real Estate Appraisal

Professionally Appraised

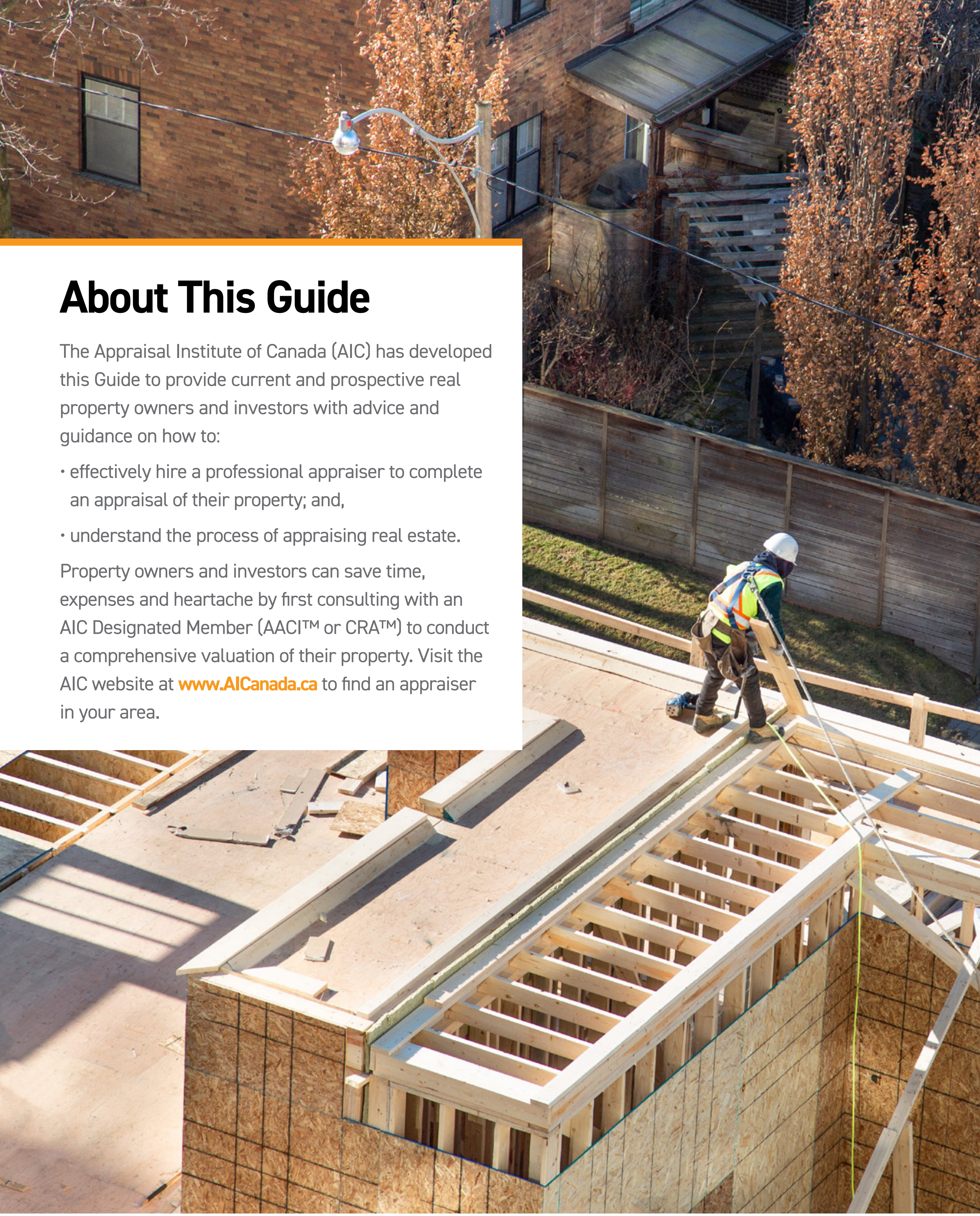
Contents

About This Guide

The Appraisal Institute of Canada (AIC) has developed this Guide to provide current and prospective real property owners and investors with advice and guidance on how to:

- effectively hire a professional appraiser to complete an appraisal of their property; and,
- understand the process of appraising real estate.

Property owners and investors can save time, expenses and heartache by first consulting with an AIC Designated Member (AACI™ or CRA™) to conduct a comprehensive valuation of their property. Visit the AIC website at **www.AICanada.ca** to find an appraiser in your area.



1 ABOUT THE APPRAISAL INSTITUTE OF CANADA

Founded in 1938, the Appraisal Institute of Canada (AIC) is the premier real property valuation association in Canada. The AIC is a self-regulating professional organization with over 5400 Members across the country.

Education and Accreditation

AIC grants the distinguished Accredited Appraiser Canadian Institute - **AACI™** and Canadian Residential Appraiser - **CRA™** designations to individuals across Canada and around the world.

An **AACI™** Designated Member may undertake any real property assignment where they have demonstrated competence with the real property type and the geographic and market influences that impact value. Property types can include but are not limited to: residential, commercial, industrial, institutional, agricultural, land and special use.

A **CRA™** Designated Member may undertake a residential real property assignment where they have demonstrated competence with the residential property type and the geographic and market influences that impact value on residential dwellings containing not more than four (4) self-contained family housing units or an individual undeveloped residential dwelling site.

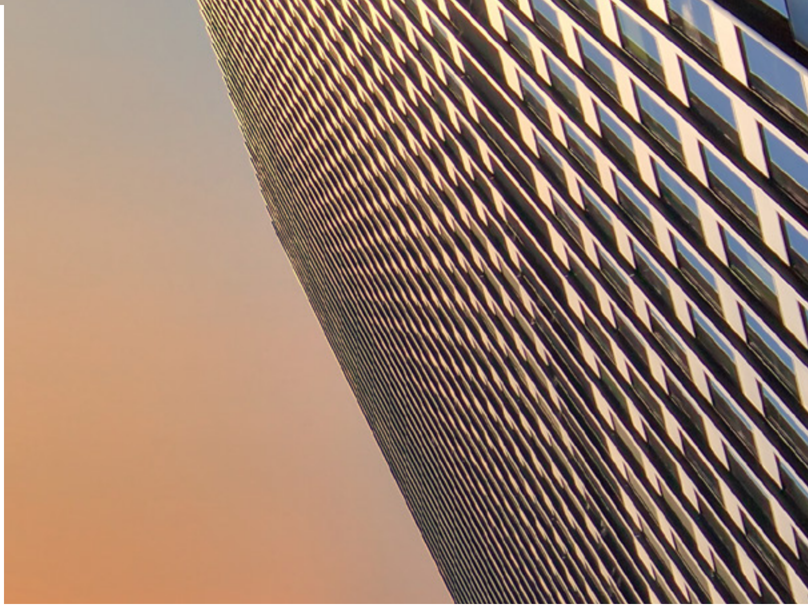
These designations recognize highly qualified individuals who have completed the AIC's rigorous curriculum, experience and examination requirements. Wherever the Member's name appears, their AIC designation or their status as an AIC Candidate Member shall be included. This is intended to include letters of transmittal, report, certification, and any correspondence pertaining to the member's scope of professional real property appraisal, appraisal review and consulting services.

2 AIC STANDARDS OF PROFESSIONAL APPRAISAL PRACTICE (CUSPAP)

The AIC has established ethics and standards commonly known as Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP) to help ensure members fulfill their professional and ethical responsibility to provide an independent and unbiased opinion of the value a property to their clients, AIC members are required to engage in Continuing Professional Development activities to ensure they maintain their skills. In addition to the requirement to comply to CUSPAP, in some provinces, AIC members are also subject to provincial licensing requirements (i.e. Alberta, Nova Scotia and New Brunswick).

A designated appraiser must also abide by AIC's Code of Professional Conduct in undertaking any appraisal assignment and be registered in AIC's mandatory Professional Liability Insurance Program.

> **AIC** encourages consumers and investors to engage qualified real estate appraisers affiliated with a strong professional association such as the AIC to obtain an independent valuation of their property prior to developing, buying, financing, renovating or refinancing.

3 IMPORTANCE OF HAVING A QUALIFIED AIC APPRAISAL PROFESSIONAL AMONG YOUR TEAM OF EXPERTS

AIC Members are engaged by a wide range of clients to provide a professional and independent opinion on the quality, value or utility of a specific property. Whenever real estate is sold, mortgaged, assessed, insured, or developed, an AIC-designated appraiser should be part of your team of experts.

Value-Add of an AIC-Designated Appraiser

It is important to know the real value of a property before making any business or personal decisions. AIC-designated appraisers are highly qualified professionals, who are trained to complete real property appraisal, appraisal review, consulting, reserve fund studies, machinery and equipment valuations and mass appraisals assignments within their area of competence.

An AIC Designated Member may provide valuation services on many types of real property including, but not limited to:

- residential dwellings
- shopping centers
- hotels and other lodging facilities
- office buildings
- rental properties
- condominiums
- industrial sites
- vacant land, parking sites
- special purpose properties
- recreational properties
- agricultural properties
- retirement and long-term care facilities

Experts in Their Field

With the breadth and depth of the AIC's membership comes specialized expertise in niche areas such as, but not limited to:

- arbitration, mediation, negotiation
- expert testimony, litigation support
- due diligence and best practice
- business valuation
- tax assessment appeals
- feasibility studies
- cost-benefit studies
- market analysis and market rent studies
- reserve fund studies
- asset/portfolio management

AIC Designated Members are the Canada's Appraisal Professionals of Choice

TIPS TO HIRING A REAL ESTATE APPRAISER

1 Ask the appraiser for their professional designation. Be sure the appraiser is a member of strong professional association such as the Appraisal Institute of Canada.
Go to **AICanada.ca** to "Find an appraiser".

2 Ask the professional appraiser about his/her qualifications; ensure the AIC member holds either the AACI (Accredited Appraiser Canadian Institute) or CRA (Canadian Residential Appraiser) designation or is an AIC Candidate Member.

3 Ask the professional appraiser about his/her competence, experience and expertise in the valuation of your type of property.

4 Ask the professional appraiser how much they will charge for appraising your property and what the fee includes.

5 Ask for and verify references.

4.2 Terms of Reference of the Appraisal Assignment

The Terms of Reference for the appraisal assignment should be in writing and agreed to by the parties prior to the assignment, to avoid any misunderstanding or additional work to amend the valuation report. The typical terms and conditions that should be taken into consideration when hiring a designated appraiser include the following:

- **Appraiser's Client:** The client is not necessarily the one who pays for the report but rather the one ordering the appraisal report. The client will provide the appraiser with instructions regarding the amount and type of information they will require in order to make a financial (e.g. mortgage lending, investment, etc.) decision based on the report.
- **Purpose of the Appraisal Assignment:** The purpose of the appraisal states what value is being estimated in response to the client's intended use or needs.
- **Intended Use of the Appraisal Report:** Identifies the client's intended use of the appraiser's reported opinions and conclusions in the appraisal report (i.e. first mortgage financing, refinancing). This guides the appraiser in determining the scope of work required for the report to allow the client to make an informed decision.
- **Intended User(s) of the Appraisal Report:** Names any other person that is to be provided with a copy of the report. Anyone wishing to obtain a copy of and use the appraisal report must contact the appraiser's client. The appraiser can only provide a copy of the report to the property owner (if not the client) or a third party if the appraiser obtains his or her client's permission - preferably in writing.
- **Effective Date of the Appraisal Report:** This can be the date of inspection or any other date that may be reasonable given the intended use. The date can be current, past ("retrospective") or future ("prospective").
- **Assumptions Made in the Analysis and Limiting Conditions that may Impact the Value:** Specific conditions to an appraisal assignment known as Assumptions and Limiting Conditions should be discussed in advance and confirmed in writing by the appraiser as being appropriate for the valuation.
- **Conflict of Interest:** The appraiser must disclose any conflict prior to taking on an assignment or as soon as uncovered once the appraisal assignment has started. Depending on the nature of the conflict, the appraiser may need to decline an appraisal assignment.
- **Type of Appraisal Report:** The type of property being appraised and the complexity of the appraisal assignment will typically determine the type of report that will be required as well as the corresponding appraisal fee. Common types of appraisal reports are:
  - **Form Reports** are completed on a templated form and are often used for the valuation of residential and small rental (1-4 units) properties.
  - **Narrative Reports** are written in a narrative format and set out the research, conclusions and rationale supporting the opinion and conclusions and are used more often for more complex appraisal assignments.

  Regardless of format, an AIC appraiser's report must comply with the CUSPAP.
- **Appraisal Fee:** An agreement on the fee charged for completing the appraisal assignment and identification of the party responsible for making the payment should be negotiated prior to starting the appraisal assignment. As mentioned above, the fee depends on the complexity of the appraisal assignment.
- **Due Date:** This refers to the date that the final valuation report is expected to be delivered to the client.
- **Appraiser's Certification of Value:** An AIC Designated Member must sign a Certification at the end of an appraisal report to certify his or her acceptance of responsibility for the appraisal and the contents of the appraisal report.

5 UNDERSTANDING THE VALUATION PROCESS

5.1 Key Elements of the Valuation Process

Scope of Work: The type and extent of research and analysis in an appraisal assignment includes, but is not limited to:

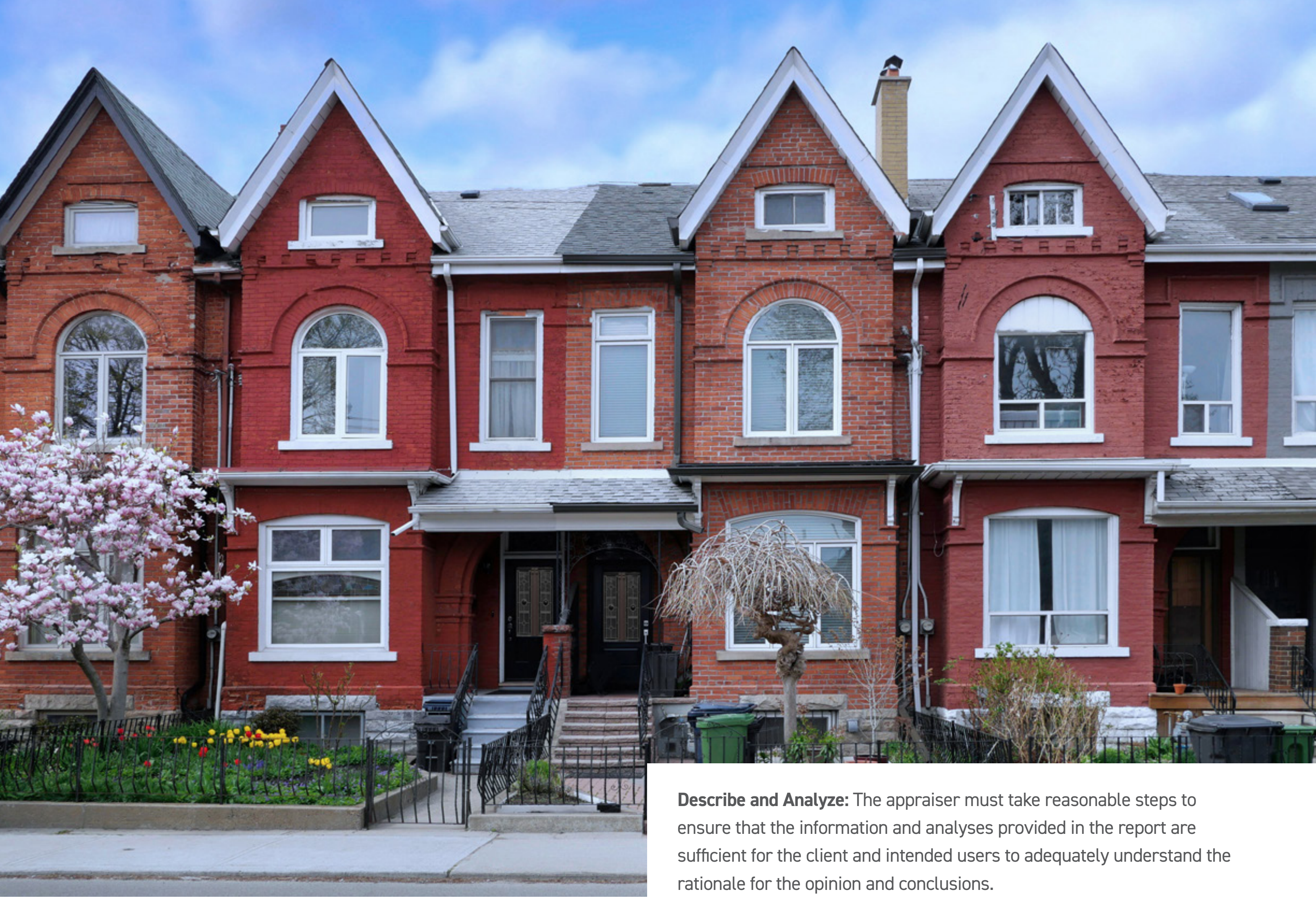
- the degree to which the property is inspected or identified;
- the extent of research into physical or economic factors that could affect the property;
- the extent of data research; and
- the type and extent of analysis applied to arrive at opinions or conclusions.

Real Property Ownership and Interests: Real property includes all interests, benefits, and rights inherent in the ownership of real estate.

Bundle of Rights: Ownership rights include the right to use real estate, to sell it, to lease it, to mortgage it, to give it away or to choose to exercise all or none of the rights. Land and everything attached to the land is considered real estate. Real estate appraising involves the valuation of an individual's right to own or use the land.

- *Fee simple* is the most complete form of ownership. A person who owns all the property rights is said to have fee simple title, which implies absolute ownership unencumbered by any other interest or estate.
- *Leased fee estate* is an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others. This is the most commonly valued property interest for income-producing properties. The lessor and the lessee each have partial interests: the leased fee interest (lessor or landlord) and the leasehold interest (lessee or tenant). Leases specify the rights of both the lessor and the lessee.

- *Taxation* is the right of government to raise revenue through assessments on valuable goods, products, services and rights. The right to tax a property is reserved for provincial and local governments.
- *Expropriation* is the right of government to take private property for public use; all of part of the owner's rights may be acquired and usually just compensation is paid to the owner.
- *Police power* is the right of government through which property is regulated to protect public safety, health, morals and general welfare (i.e. zoning, use restrictions, building codes, environmental regulations).
- *Escheat* is the right of government that gives the government titular ownership of a property when its owner dies without a will or any statutory heirs.



Describe and Analyze: The appraiser must take reasonable steps to ensure that the information and analyses provided in the report are sufficient for the client and intended users to adequately understand the rationale for the opinion and conclusions.

All three valuation approaches (Direct Comparison Approach, Cost Approach and Income Approach as described in Section 5.3) require the collection of comparable data. The decision to inspect comparables and the extent of verification of data will be determined by the scope of the work involved in the assignment.

Characteristics of the Property: Relevant to the purpose and intended use of the report, the following must be analyzed and included in the report:

- the property identification by civic address and/or legal description or other reference to describe the location of the property;
- the real property interest to be valued;
- physical, legal and economic attributes;
- any personal property, trade fixtures or intangible items that are not real property but are included in the value of the property;
- any known or apparent title restrictions, easements, encumbrances, leases, reservations, covenants, contracts, judgments, special assessments, liens, or other items of a similar nature;
- consideration of known detrimental conditions; and,
- the extent of inspection of the subject property.

Zoning and Land Use Controls: The appraiser must identify the zoning for the subject and analyze the effect of land use controls on the use and value of the site, along with any probable modifications due to changes in regulations (i.e. at the municipal, provincial and/or federal levels).

Highest and Best Use: The highest and best use of a property in usually considered to be the most probable use of a property that is physically possible, legally permitted, financially feasible and the most productive to result in the highest value. The report must contain the appraiser's opinion as to the highest and best use of the property being appraised. If the purpose of the assignment is to provide a market value, the appraiser's support and rationale for the opinion of highest and best use is required. As land is usually appraised as though vacant and available for development to its highest and best use, the appraiser must provide opinions as to the highest and best use of:

- the land, as if vacant; and,
- the property, if improved.

5.2 Key Elements of the Valuation Process

An inspection is just one of the many tasks performed by an appraiser. An appraiser prepares a building description by considering a variety of specific information and must be familiar with the structural details of the exterior and interior of the building that will influence value in the marketplace. The appraiser's inspection takes into account a number of elements including:

- physical characteristics of the building and any outbuilding;
- interior/exterior finishes of the building;
- equipment and mechanical systems (i.e. elevators, access ramps; electrical, plumbing, heating and cooling systems);
- quality of the improvements (i.e. poor, average, good, excellent);
- different types of units, their size and functionality of their layouts (i.e., adapted units, bachelor, 1, 2 or 3-bedroom units); and,
- elements of depreciation from any deficiencies or required repairs (i.e. ***physical depreciation*** - wear and tear from regular use; ***functional depreciation*** - aspects of a building that diminish function, utility and value of the improvement; ***external depreciation***- impairments due to influences outside the property).

In addition to understanding the dynamics of the real estate market, AIC-designated appraisers also have construction skills and knowledge, which are fundamental to their training. Members also rely on the expertise of industry professionals where building characteristics are more complex.

> **BE AWARE!** Property owners must be mindful that under the Personal Information Protection and Electronic Document Act (PIPEDA), the appraiser must obtain the occupant's consent (i.e. tenant in multi-residential properties) either in writing or verbally, prior to taking interior photographs.

In addition to understanding the dynamics of the real estate market, AIC-designated appraisers also have construction skills and knowledge, which are fundamental to their training. Members also rely on the expertise of industry professionals where building characteristics are more complex.

As part of the inspection process, the appraiser will:

- set a convenient time for an inspection; where the property is tenant occupied, sufficient notice to tenants is required and must be in accordance with the provisions in their lease;
- collect as much information as possible during the inspection to provide the Client and any Intended User with a detailed account of the design, layout and construction details of the property's improvements and the improvements typically accepted in the subject market.
- take interior and exterior photographs to provide a visual representation of the data described in the report. Exterior photographs are important to clearly identify the property and its characteristics. Sometimes, interior photographs are requested by the appraiser's client or required; the taking of tenant-occupied units requires the occupant's consent (preferably written).
- ask about important features of the property such as the original date of construction, dates of any major additions or renovations, and extra features, to name a few.
- gather information about recent marketing activity on the property (i.e. sales and listing history). While public information is often available, the appraiser may inquire about any listings of the property (including private listings) or offers to purchase in the past twelve months, as well as any sales of the property for the previous three years.

Reasoning: Reasoning requires the logical review, analyses and interpretation of the data in a manner that would support the conclusion and not mislead the reader.

Agreement for Sale/Option/Listing: Any agreement for sale, option, lease, if applicable, or listing of the subject property that occurred within 1 year prior to the date of valuation, including any pending/current Contract of Purchase and Sale or lease, if such information is available, must be analyzed and reported by the appraiser.

Prior Sales: Any sale of the subject property that occurred within 3 years prior to the effective date of the appraisal, if such information is available as at the date of valuation, must be analyzed and reported by the appraiser. Additionally, any impact on the price paid under known undue stimulus must be reported in the appraisal report.

5.3 Valuation Methodologies

5.3.1 Direct Comparison Approach

When the Direct Comparison Approach is applicable, the appraiser develops an opinion of value by analyzing completed sales, listings or pending sales of properties that are similar to the subject property. Estimates of market rent, expenses, land value, cost, depreciation and other value parameters may be derived using a comparative technique.

The Direct Comparison Approach is the process of:

- Comparing properties similar to the subject property that have recently sold;
- Identifying appropriate units of comparison (i.e. price per square foot, price per square metre, price per acre, price per room, price per unit, etc.);
- Making adjustments to the sale prices (or unit prices) of the comparable properties based on market-derived elements of comparison; and,
- Reconciling the adjusted sales prices (or unit prices) of the comparable properties into an opinion of value, either a single point value or a range of value.

Various analytical techniques may be used to identify and measure adjustments, which may be quantitative or qualitative. The first step in the comparative analysis is to identify which elements of comparison affect property values in the subject market. Each of the elements is tested by one or more techniques to determine whether market data supports an adjustment.

Paired data set analysis is a process in which two or more market sales are compared to derive an indication of the size of the adjustment for a single characteristic. Ideally the sales being compared will be identical in all respects except for the element being measured; however, this is rarely the case. Frequently, an appraiser must undertake a series of paired data set analyses to isolate the effect of a single characteristic, which can be complex when the subject property offers distinct and unique characteristics from the market. When limited data is available, the appraiser will use other analytical procedures to test the reasonableness of an adjustment.

As part of the reconciliation process, the appraiser must review and reconcile:

- the quality and quantity of data available and analyzed within the valuation approaches used; and,
- the applicability and reliability of those approaches in the context of the scope of the assignment.

The result is a final value which may be a single point value or a range of values.

Comparable sales analysis can provide information used in the other approaches such as overall capitalization rates for the Income Approach or depreciation estimates for the Cost Approach (see sections 5.3.2 and 5.3.3 below). Income multipliers, capitalization rates, and yield rates are applied in the Income Approach but appraisers extract such rates and factors from comparable properties in the direct comparison analysis.

The following grid allows the appraiser to define the units of comparison and list the locational, physical and other characteristics of the subject and the comparable properties in order to complete the comparative analysis. Market-derived quantitative and/or qualitative adjustments are applied to adjust the sale price of each comparable property to equate it to the subject property.

Comparative Analysis Grid

Subject		Comparable No. 1		Comparable No. 2		Comparable No. 3	
		Description	Adjustment	Description	Adjustment	Description	Adjustment
Data Source							
Date of Sale							
Sale Price							
Days on Market							
Location							
Site Size							
Building Type							
Design/Style							
Age/Condition							
Liveable Floor Area							
Room Count							
Basement							
Parking							
Other Characteristics							
Total Adjustments							
Adjusted Values							

5.3.2 Cost Approach

The Cost Approach considers the land and building components separately, and reaches a value conclusion by adding these estimates together to form an opinion of value. Like the Direct Comparison Approach, the Cost Approach is based on a comparison of the cost to replace the subject (cost new) or the cost to reproduce the subject (substitute property). The total cost estimate is then adjusted by deducting the accrued depreciation in the subject property. Land value is also estimated and added to the building value.

When the Cost Approach is applicable, an appraiser must:

Step 1: Estimate the value of the site as though vacant and available to be developed to its highest and best use; this is based on comparable land sales data, using the same process as previously described in the Direct Comparison Approach or some other appropriate appraisal method or technique.

Step 2: Depreciated Cost of the Improvements =

- Estimated cost new of the improvements (i.e. building, garage, outbuilding) using comparable data +
- Estimated appropriate entrepreneurial profit or incentive from the market +
- Estimated contributory value of any site improvements (i.e. landscaping, other site improvements) that have not been considered -
- Estimated accrued depreciation in the subject (all physical, functional and external elements of depreciation)

Step 3: Value by the Cost Approach = Estimated Value of the Site as Though Vacant + Depreciated Costs of Improvements

5.3.3 Income Approach

Income-producing properties are typically purchased as investments and the earning potential is an important element affecting the value. Through the Income Approach, the appraiser analyzes a property's capacity to generate income and converts the net income into a present value.

In estimating the market value of an income-producing property, the appraiser analyzes the income and expenses of comparable rental properties to estimate a stabilized level of net income. The income of investment properties consists primarily of rent with market rent being the "most probable rent that a property should bring in a competitive and open market reflecting all conditions and restrictions of typical lease agreement …. ". Rent, defined through a lease, can be based on a number of units of comparison (i.e. annual rent, rent per unit, rent per floor area of building, e.g. $X per square foot) and the lease would specify the operating expenses incurred by the landlord and those incurred by the tenant.

Potential Gross Income: is the total potential income the property can generate at full capacity (with no vacancy and before operating expenses). The appraiser analyzes trends, forecasts and comparable rental data to estimate the market rental of the property.

Vacancy Allowance and Collection Losses: covers the loss of income resulting from unoccupied space, tenant turnover and potential credit loss (non-payment of rent by the tenants).

Effective Gross Income: is the expected income from all sources (i.e. rent from tenants, laundry income, parking income, other income) less a market-derived vacancy allowance for each source of income.

Operating Expenses: are periodic expenditures incurred to operate the subject property. These include, but are not limited to: fixed expenses (e.g. property taxes, insurance, utility expenses, maintenance, property management), variable expenses, and sometimes replacement allowance (also known as reserves for replacement of capital items - which apply to some types of property).

Net Operating Income: is the remaining income net of all operating expenses. It excludes expenses related to mortgage debt and book depreciation, which are capital (not operating) expenses.

Converting Income into Value: The value of a property is estimated by converting or "capitalizing" the property's net annual income by an appropriate rate – this can be through an overall capitalization rate, a discount rate or a number of other techniques. This Guide focuses on the Overall Capitalization Rate but depending on the property rights being appraised and/or the purpose of the appraisal it is important to note that other income, discount or yield techniques can be applied.

An Overall Capitalization Rate (OCR) converts a single year's Net Operating Income for the subject property into an indication of value. The Overall Capitalization Rate is derived from analysis of the comparable sales data through a similar analysis of their respective Effective Gross Income, Operating Expenses and Net Operating Income. The Overall Capitalization Rate of a comparable sale is its Net Operating Income divided by its Sale Price.

For example, an income-producing property sold for $1,000,000 with an annual Net Operating Income of $60,000 which translates into a market derived Overall Capitalization Rate of 6%:

Net Operating Income:	$ 60,000 = 0.06 (6% = OCR)
Sale Price:	$1,000,000

The appraiser will derive the Overall Capitalization Rate for all comparable sales data analyzed and reconcile into an applicable Overall Capitalization Rate to convert the subject property's income into a single point of value.

5.4 Reconciliation and Certification

Review and Reconcile: The appraiser must review and reconcile:

- the quality and quantity of data available and its analysis in the valuation approaches used; and,
- the applicability and reliability of those approaches in the context of the scope of the assignment.

Final Value: The final value may be a single point value, a range of values or an indication of value.

Certification of Value: Each written real property appraisal report must contain a signed Certification of Value. The member(s) signing the Certification of Value of an appraisal report is (are) responsible for the entire report, including the content, analysis and conclusions.

5.5 The Appraisal Report

Each analysis, opinion and conclusion that results from an appraisal must be communicated in a manner that is meaningful to the intended user and will not be misleading. Members of the Appraisal Institute of Canada are required to complete their appraisal assignments and activities in compliance with the requirements of the Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP). Whether the appraiser completes an appraisal assignment using a form or narrative report format, the elements outlined in this Guide are critical to ensure completeness of information and compliance to AIC Standards. Below is a sample report outline.

Sample Report Outline Compliant to CUSPAP

Basis of the Appraisal

- Intended Use of the Report
- Purpose of the Assignment
- Property Rights Appraised
- Definition of Value
- Effective Date of Value
- Scope of Work
- Assumptions and Limiting Conditions

Factual Information

- Identification of the Property, Including Title Information
- Area, City and Neighbourhood Data
- Site Information
- Building Description
- Existing Use
- Property Assessment and Taxes
- Sales History
- Land Use Controls

Analyses and Conclusions

- Characteristics of the Market
- Highest and Best Use of the Land as if Vacant
- Highest and Best Use of the Property as Improved
- Appraisal Procedures
- Land Value
- Cost Analysis
- Income Analysis
- Direct Comparison Analysis
- Reconciliation
- Final Value Estimate and Exposure Time Analysis
- Certification of Value

Addenda

- Appropriate Plans and Maps
- Relevant Documents
- Photographs

This Guide was originally authored by Nathalie Roy-Patenaude (AACI, P.App), AIC's Director, Professional Practice (March 2013) and updated in January 2018.

For more information on understanding the appraisal process, please contact the Appraisal Institute of Canada at info@aicanada.ca or find an appraiser in your area by visiting the AIC website at www.AICanada.ca.

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