

Chapter 12: Understanding Appraisals

## Chapter 12

# Understanding Appraisals

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Chapter 12: Understanding Appraisals

## Chapter Objectives

- Identify the steps necessary to complete a real estate appraisal.
- Contrast the three appraisal approaches used to arrive at an opinion of value.
- Identify the elements recorded on a Uniform Residential Appraisal Report (URAR).
- Describe how adjustments are made to comparable properties.
- Discuss the impact of rules on appraisal independence.

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## Appraisal

- Estimate or opinion of value as of a certain date that is supported by objective data
  - Not a guarantee of value
  - Date establishes terms, conditions, economic circumstances

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**Class Activity** Reasons for Appraisals

- Collateral (lender)
- Listing price (seller)
- Offer price (buyer)
- Civil lawsuits
- Divorces
- Bankruptcies
- Estates and trusts
- Eminent domain valuations
- Insurance coverage or claims
- Tax matters
- Construction/remodeling costs

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Appraisal Approaches

- **Sales comparison approach**
  - Compares property being appraised with other similar properties (comparables or comps) sold recently in the same market area; best for residential properties
- **Cost approach**
  - Calculates cost of the land, site improvements, and to build the structure, any depreciation; best for relatively new construction and unusual or special purpose properties with few or no comparables and that do not produce income
- **Income approach (capitalization approach)**
  - Estimates value by analyzing current or potential revenue compared it to other similar properties; best for commercial or investment properties

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USPAP

- Uniform Standards of Professional Appraisal Practice (USPAP) established and promoted by the Appraisal Foundation
- Dictates standards, rules, and guidelines that licensed appraisers must follow
- Written reports—Uniform Residential Appraisal Report (URAR)—must also adhere to certain standards
- Complete assignment workfile must show all data and documentation necessary to support opinion of value

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## URAR

- Uniform Residential Appraisal Report (URAR) communicates opinion of value with evidence
- Fannie Mae Form 1004 or Freddie Mac Form 70
- Used for single-family homes, individual units in a planned unit development (PUD), or other one-family properties
  - Condominiums (Form 1073)
  - Multi-family investment properties (Form 1025)
  - Manufactured homes (Form 1004C)
- Based on interior and exterior inspection
- Lender is authorized use regardless of who pays

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## Sales Comparison Approach

- Compares subject property with other recently sold properties in the same location (comps)
- Considered most useful since based on actual market activity
- Should evaluate as many comps as necessary to arrive at value opinion
- Only looks at past sales that have closed
- Looking for market value (most probable selling price)
- Opinions must be based on typical buyer without undue influence
- URAR allows documentation of current listings

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## Finding Comparable Sales

- Typically between 3 and 5 comps
  - Secondary market requires 3 minimum
- Should be recent sales (within 6 months)
- Ideally, from same neighborhood
- Close in style and other features
- Same transfer of rights
- Part of an arm's length transaction
  - Typical conditions in marketplace
  - Buyer and seller acting in own best interest

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## Adjusting Properties

- Comps should be as close as possible in features to the subject to allow meaningful price comparisons
  1. Subject property is the starting point; it *never changes*
  2. If the comp is missing a feature the subject has, *add* to the comp to make the properties equal
  3. If the comp has a feature the subject does not, *subtract* from the comp to make them equal

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Class Activity

## Adjustments

	Subject Property 	Comparable 1 	Comparable 2 	Comparable 3 
Feature	1-car garage	No garage	1-car garage	2-car garage
Adjustment Needed	NEVER ADJUST	ADD \$5,000	NO CHANGE	SUBTRACT \$5,000
Pre-Adjustment Value		\$91,000	\$100,000	\$110,000
Final Value	???	\$96,000	\$100,000	\$105,000

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## Adjustment Considerations

- Adjustments made only as of day comp is sold
- Adjustments made only for significant features:
  - Physical features
  - Features of the transaction
- Only features contributing to difference in price are included

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## Adjustment Limits

- Adjustments to comps limited by Fannie Mae
  - Provides benchmark on how close the comps are to the subject
  - Adjustments outside guidelines require explanation
  - Individual line adjustments should not exceed 10%
- Total net should not exceed 15% of the comp sale price
  - All adjustments added and subtracted
- Total gross should not exceed 25% of the comp sale price
  - All adjustments added without regard to sign

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Class Activity

## Adjustment Limits

Property #1

- Comp sold for \$85,000. Positive adjustments for garage (+\$3,000) and half bath (+\$1,500); negative adjustment for basement (-\$2,500).
- **$3,000 + 1,500 - 2,500 = \$2,000$ ;  $\$2,000 / \$85,000 = 2.4\%$ , acceptable**

Property #2

- Comp sold for \$55,000. Positive adjustment for half bath (+\$1,500); negative adjustments for owner financing (-10% = -\$5,500), basement (-\$2,500) and garage (-\$3,000).
- **$1,500 - 5,500 - 2,500 - 3,000 = -\$9,500$ ;  $\$9,500 / \$55,000 = 17.3\%$ , exceeds**

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Class Activity

## Adjustment Limits

Property #3:

- Comp sold for \$55,000. Positive adjustments for garage (+\$3,000), half bath (+\$1,500); negative adjustments for owner financing (-\$5,500), basement (-\$2,500), bedroom (-\$2,000).
- **$3,000 + 1,500 + 5,500 + 2,500 + 2,000 = \$14,500$ . Total absolute value of all adjustments exceeds 25% limit:  $(\$55,000 \times 25\% = \$13,750)$**

Property #4:

- Comp sold for \$95,000. Positive adjustments for basement (+\$2,500), bedroom (+\$2,000); negative adjustment for garage (-\$3,000).
- **$2,500 + 2,000 + 3,000 = \$7,500$ . Total absolute value of all adjustments (without regard to sign) is less than 25%:  $(\$95,000 \times 25\% = \$23,750)$**

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### Sequence of Adjustments

Element of Comparison	Market Indicated Adjustment	Adjustment to Comparable
Sale Price	—	\$136,000
Property Rights Conveyed	+5%	+ \$6,800
Adjusted Price	—	\$142,800
Financing Terms	-3%	- \$4,284
Adjusted Price	—	\$138,516
Market Conditions	+7%	+ \$9,696
Adjusted Price	—	\$148,212
Location	+11,000	+ 11,000
Physical Characteristics	-\$7,500	- \$7,500
Value Indication		\$151,712

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- ### Adjustments: Property Rights
- Most transactions are fee simple
    - All property rights transferred with ownership
  - Some exceptions, such as leasehold interest
    - Detailed analysis required to determine appropriate percentage adjustment
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- ### Adjustments: Financing Terms
- Any unusual seller concession must be considered, e.g.:
    - Interest rate buydowns
    - Refunds or credits
    - Discount points
    - Personal property
    - Fees, closing costs
    - Assumptions
  - Looking for “sale price adjusted to cash equivalency”
  - Adjustment based on percentage of sale price
  - Fannie Mae requirements:
    - Dollar amount of concessions must be documented
    - Adjustment must reflect influence of concession
    - Positive adjustments not permitted
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## Adjustments: Market Conditions

- Must consider date of sale and market conditions
- Survey market to determine if adjustment required
- Property value increase/decrease reflected as percentage
- Fannie Mae guidelines:
  - At least 3 comps that have closed
  - Comps older than 6 months require explanation
  - May use older or pending sales with justification

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## Adjustments: Location

- Market area where the comparable is located
  - Same established subdivision is best comp
- Exact position within a neighborhood a factor
- Rural properties a challenge
  - Can use outside of market area with explanation
- Adjustment made as a dollar value
- Fannie Mae guidelines:
  - Very specific description of location proximity required, even if no adjustment

FEATURE	SUBJECT	COMPARABLE SALE # 1	COMPARABLE SALE # 2	COMPARABLE SALE # 3
Address	22 OAKWOOD DRIVE WESTERVILLE, OH 43081	21 VALLEYVIEW COURT WESTERVILLE, OHIO	337 CHRIS COURT WESTERVILLE, OHIO	321 PEARSON DRIVE WESTERVILLE, OHIO
Proximity to Subject		0.37 MILE NORTHEAST	0.33 MILE NORTH	0.82 MILE SOUTHEAST
Sale Price	\$ 178,000	\$ 180,000	\$ 185,000	\$ 172,000
Size (Square Feet)	1,200	1,200	1,200	1,200

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## Adjustments: Physical Characteristics

- Documented even if no adjustment needed
- Ideally, comps should have few adjustments
- Quality may be rated as excellent, good, average, fair, poor
- Adjustment made as a dollar value
- Fannie Mae guidelines:
  - Only contributory features should be adjusted
  - Below grade areas considered separately from gross living area (finished, heated, above grade)
  - Bathrooms and foyers not included as rooms
  - Bedrooms must have a closet

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### Adjustments: Physical Characteristics

Design (Style)	COLONIAL/2ST	COLONIAL/2ST	COLONIAL/2ST	COLONIAL/2ST				
Quality of Construction	AVERAGE	AVERAGE	AVERAGE	AVERAGE				
Actual Age	6 YEARS	5 YEARS	6 YEARS	8 YEARS				
Condition	GOOD	GOOD	GOOD	AVERAGE			+2,500	
	Total Baths	Total Baths	Total Baths	Total Baths				
Room Count	7   3   2.1	6   3   2.1	8   3   2.1	7   3   2				+500
Gross Living Area	1,952 sq ft	2,004 sq ft	-1,250   1,904 sq ft	+1,250   1,729 sq ft				+5,500
Basement & Finished	642 Sq Ft	1,002 SQ. FT.	-2,000 700 SQ. FT.	600 SQ. FT.				
Rooms Below Grade	2 RMS, F BA	UNFINISHED	+3,000 1 RM. FIN	+2,000 2 RMS, F BA				
Functional Utility	AVERAGE	AVERAGE	AVERAGE	AVERAGE				
Heating/Cooling	GFA/CENTRAL	GFA/CENTRAL	GFA/CENTRAL	GFA/CENTRAL				
Energy Efficient Items	TYPICAL	TYPICAL	TYPICAL	TYPICAL				
Garage/Carport	2-C ATT GAR	2-C ATT GAR	2-C ATT GAR	2-C ATT GAR				
Porch/Patio/Deck	PORCH, PATIO	PORCH, DECK	PORCH, PATIO	PORCH, DECK				
B-I SPA	NONE	NONE	+500 IN-GRD POOL	-500 B-I SPA				+500
W/D PRV/F FNC	W/D PRV/F FNC	W/D PRV/F FNC	W/D PRV/F FNC	NONE				
FIREPLACE	FIREPLACE	FIREPLACE	2 FIREPLACES	-1,000 FIREPLACE				
Net Adjustment (Total)			250	-5,750				9,000

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### Transfer History

- Determine whether previous transactions represent bona fide transfers at market value

I did not research the sale or transfer history of the subject property and comparable sales. If not, explain:

My research  did not reveal any prior sales or transfers of the subject property for the three years prior to the effective date of this appraisal.

Data Source(s) FRANKLIN COUNTY AUDITOR

My research  did reveal any prior sales or transfers of the comparable sales for the year prior to the date of sale of the comparable sale.

Data Source(s) FRANKLIN COUNTY AUDITOR

Report the results of the research and analysis of the prior sale or transfer history of the subject property and comparable sales (report additional prior sales on page 3).

ITEM	SUBJECT	COMPARABLE SALE #1	COMPARABLE SALE #2	COMPARABLE SALE #3
Date of Prior Sale/Transfer	NONE IN 36 MONTHS	9/2/2004	NONE IN 12 MONTHS	NONE IN 12 MONTHS
Prior of Prior Sale/Transfer	\$155,000			
Data Source(s)	FRANKLIN CO AUDITOR			
Effective Date of Data Source(s)	6/9/2009			

Analysis of prior sale or transfer history of the subject property and comparable sales RESEARCH REVEALED THAT SALE #1 TRANSFERRED ON 9/2/2004 FOR \$155,000. FURTHER INQUIRY WITH THE SELLER IN THE MOST RECENT TRANSACTION REVEALED THAT THE PURCHASER WAS VIA SHERIFF'S AUCTION. COSMETIC RENOVATIONS WERE PERFORMED PRIOR TO THE PROPERTY BEING RE-MARKETED.

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### Subject Transfer History

- Must analyze prior sales for past three years
- May expose flipping: Purchasing existing properties with intent of immediately reselling for a profit
  - Frequent transfers with escalating values in a short period of time may signal fraud
- Fannie Mae guidelines:
  - URUR should include analysis of sales contract, property listing, and sales history as reasonably available

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## Comparables Transfer History

- Must analyze comp prior sales for one year prior to sales date
- Comps with frequent transfers with escalating values in a short period of time should be investigated further or discarded
- If previously lender owner, may be distressed property and so not market value
- Fannie Mae guidelines:
  - Recommends rejecting comps with back-to-back, simultaneous, double transaction closings with price increases

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## Reconciliation and Indicated Value

- Reconciliation: Ongoing process of analyzing values derived from different appraisal approaches
- Sales comparison opinion of value
  - Final values are never averaged
  - Most similar comp gets most weight
- Appraiser should never steer value range to sales price target
- Fannie Mae guidelines:
  - Include narrative of thought process

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## Final Reconciliation on URAR

- Data from all appraisal approaches reconciled to arrive at a final opinion of value
- Most appropriate approach given most weight
  - Usually sales comparison on residential property
  - Fannie Mae will not accept if only cost approach used
- Fannie Mae requires final single opinion of true market value

Indicated Value by: Sales Comparison Approach \$	178,000	Cost Approach (if developed) \$	182,822	Income Approach (if developed) \$	N/A
THE COST APPROACH LENDS SUPPORT AS THE UPPER RANGE OF VALUE. THE SALES COMPARISON APPROACH HAS BEEN GIVEN THE MOST WEIGHT AS IT REFLECTS THE ACTIONS OF BUYERS AND SELLERS IN THE MARKETPLACE. THE SALES COMPARISON APPROACH IS TYPICALLY CONSIDERED TO BE THE MOST RELIABLE IN ASSIGNMENTS OF SINGLE-FAMILY DWELLINGS.					
This appraisal is made <input checked="" type="checkbox"/> "as is" <input type="checkbox"/> subject to completion per plans and specifications on the basis of a hypothetical condition that the improvements have been completed, <input type="checkbox"/> subject to the following repairs or alterations on the basis of a hypothetical condition that the repairs or alterations have been completed, or <input type="checkbox"/> subject to the following required inspection based on the extraordinary assumption that the condition or deficiency does not require alteration or repair.					
Based on a complete visual inspection of the interior and exterior areas of the subject property, defined scope of work, statement of assumptions and limiting conditions, and appraiser's certification, my (our) opinion of the market value, as defined, of the real property that is the subject of this report is \$ 178,000 as of JUNE 3, 2005, which is the date of inspection and the effective date of this appraisal.					

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### “As Is” and Recertification

- Typical appraisal performed “as is” based on thorough examination of property in its current condition
  - Could be subject to other hypothetical conditions or extraordinary assumptions
- May be necessary to update value opinion
  - New appraisal assignment with new date
- Recertification of value (completion report)
  - Confirms whether “subject to” conditions in original appraisal have been met
  - Does not change effective date of appraisal

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### Automated Valuation Models

- Provides a probable value range for properties
  - Performs statistical analysis of available data such as tax records
  - Tends to value at middle of range
- Not a true appraisal: No opinion of value
- Fannie Mae’s DU® Property Inspection Report-Form 2075
  - “Drive-by” form: Exterior only inspection

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### Hot Topic: Appraiser Independence

- HVCC went into affect in 2009
- Sets standards related to appraiser independence
- Required by Fannie Mae and Freddie Mac for 1- to 4-family home loans
- Only lender or authorized third party may select, retain, and compensate an appraiser
- Does allow brokers to initiate appraisal process with specified AMC on lender’s behalf

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**Rules on Valuation Independence**

- Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires review of HVCC
- Interim final rule prohibits coercion
  - Seeking to influence
  - Withholding/threatening to withhold payment
  - Implying future engagement dependent
  - Excluding from future engagement
  - Conditioning compensation

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**Rules on Valuation Independence**

- Allows asking appraiser to reconsider, add detail, correct error
- Allows selecting most appropriate value from multiple
- Prohibits material misrepresentation
- Prohibits conflicts of interest
- Prohibits credit extension if known violation occurs (or should have known)
- Requires reasonable and customary compensation
- Requires reporting non-compliance

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**Key Term Review**

<ul style="list-style-type: none"> <li>• Appraisal</li> <li>• Appraisal Management Company (AMC)</li> <li>• Automated Valuation Model (AVM)</li> <li>• Comparables</li> <li>• Contributory Value</li> <li>• Drive-By Appraisal</li> <li>• Gross Living Area (GLA)</li> </ul>	<ul style="list-style-type: none"> <li>• Market Value</li> <li>• Matched Pair Analysis</li> <li>• Neighborhood</li> <li>• Recertification of Value</li> <li>• Reconciliation</li> <li>• Sales Comparison Approach</li> <li>• Subject Property</li> <li>• URAR</li> <li>• USPAP</li> </ul>
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## Summary

**1. Appraisal:** An opinion of value of property, as of a specified date, supportable by objective data

- Appraisers follow well-defined process to value properties
- Three different methods: Sales comparison approach, cost approach, and income approach.
- **Uniform Standards of Professional Appraisal Practice (USPAP)** rules and guidelines must be followed for completeness, accuracy, and objectivity
- **Uniform Residential Appraisal Report (URAR)** is the primary form used by lenders for residential property appraisal; communicates opinion of value and the supporting data

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## Summary

**2. Sales comparison approach** estimates property value by comparing the subject property with other recently sold comparable properties in the same market area

- Fannie Mae requires at least 3 comps
- Only past sales are used since they are objective evidence.
- **Market value** is the most probable price a property should bring in a competitive and open market
- Typical buyers, acting in their own best interest, won't pay more for a home or feature than a comparable substitute

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## Summary

**3. Comparables** must be similar to the subject, recent sales, and in the same market area

- **Adjustments** are made to comparables for differences; the subject never changes
- Comp lacks something the subject has, add value
- Comparable has something extra, subtract value
- Adjust only for features present or absent as of the day a comparable was sold
- Adjust only for significant features

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## Summary

4. Sequence of adjustments:

1. Property rights conveyed (percentage adjustment)
2. Financing terms (percentage adjustment)
3. Conditions of sale (percentage adjustment)
4. Market conditions/date of sale (percentage adjustment)
5. Location (dollar adjustment)
6. Physical characteristics (dollar adjustment)
  - Fannie Mae adjustment guidelines:
    - Individual line adjustment should not exceed **10%** of comp
    - **Net** adjustments should not exceed **15%** of comp
    - **Gross** adjustments should not exceed **25%** of comp

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## Summary

5. Subject **transfer history**

- Past three years to check for inflated prices
- Property flipping is buying property and quickly reselling it for a profit; not illegal, fraud can occur if property value is inflated
- Frequent transfers with escalating values in a short time are warning signs
- Comparable transfer history for the year prior to the date of transfer
- Determine if transfer price actually reflects market value
- Discard comps with multiple transfers with escalating values (or "back-to-back," "simultaneous," or "double" transaction closings)

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## Summary

6. Reconciliation: Process of analyzing values derived from different appraisal approaches to arrive at a final opinion of value

- Values of the different approaches are never averaged to reach a final value.
- Section indicates if "as-is" appraisal or is subject to other conditions or assumptions, which require additional explanation

7. Automated valuation model (AVM) provides probable value range for properties by performing a statistical analysis of available data; used with automated underwriting

8. Updated or readdressed appraisal, as when a lender evaluates an application, is considered a new assignment; a recertification of value (recert) confirms if conditions in original appraisal have been met; does not change effective date

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## Summary

9. Final interim rule on valuation independence

- Set standards on compensation, conflicts of interest, and appraiser independence
- Intended to ensure appraisers are not coerced *in any way* into establishing a pre-determined or desired valuation on a property

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## Chapter 12 Quiz

1. Which form is used most frequently for residential appraisals?

- A. FNMA
- B. HVCC
- C. URAR
- D. USPAP

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## Chapter 12 Quiz

2. Jack has been contracted to determine the value of a large apartment building for a potential investor. Which appraisal method is probably the most useful for this situation?

- A. competitive market analysis
- B. cost approach
- C. income approach
- D. sales comparison approach

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### Chapter 12 Quiz

**3. Which of the following is a correct adjustment?**

- A. The comparable has an extra bathroom, so \$3,000 is added to the subject price.
- B. The comparable has an extra bathroom, so \$3,000 is subtracted from the subject price.
- C. The subject has an extra bathroom, so \$3,000 is added to the comparable price.
- D. The subject has an extra bathroom, so \$3,000 is subtracted from the comparable price.

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### Chapter 12 Quiz

**4. Two homes are similar in every respect except one has air conditioning and the other has a heat pump. Both sold for \$125,000. What can we conclude?**

- A. Air conditioning is more desirable than a heat pump.
- B. A heat pump is more desirable than air conditioning.
- C. Neither a heat pump nor air conditioning is a significant feature.
- D. There must be some information missing from the question because air conditioning is always worth more.

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Chapter 12: Understanding Appraisals

### Chapter 12 Quiz

**5. Which is considered first in the sequence of adjustments?**

- A. date of sale
- B. location
- C. physical differences
- D. property rights conveyed

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Chapter 12: Understanding Appraisals

**Chapter 12 Quiz**

**6. When a percentage adjustment is made for a sale concession, what is the result?**

- A. The comparable price is now the cash equivalency.
- B. The comparable price is now the time-adjusted normal sale price.
- C. The subject is adjusted to the market.
- D. Nothing, because sales concessions are never percentage adjustments.

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Chapter 12: Understanding Appraisals

**Chapter 12 Quiz**

**7. Why are there guidelines on adjustment limits?**

- A. because lenders wanted to limit the number of loans being made
- B. so appraisers do not adjust the subject too much
- C. to gauge how close a comparable approximates the subject
- D. to test which appraisers are more adept at math skills

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Chapter 12: Understanding Appraisals

**Chapter 12 Quiz**

**8. On the URAR form, the transfer history for the subject must be reported for**

- A. any suspicious transfers in the public record.
- B. the past three years.
- C. the past year.
- D. The past six months.

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Chapter 12: Understanding Appraisals

**Chapter 12 Quiz**

**9. A recert does NOT**

- A. address issues in a "subject to" appraisal.
- B. change the effective date of the valuation.
- C. confirm the validity of the original opinion of value.
- D. verify that conditions stated in the original appraisal have been met.

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Chapter 12: Understanding Appraisals

**Chapter 12 Quiz**

**10. Under the provisions of the interim final rule on valuation independence, which would NOT be prohibited?**

- A. asking an appraiser to report a specific property value
- B. conditioning compensation to an appraiser based on consummation of the transaction
- C. obtaining multiple valuations and selecting the most reliable
- D. refusing to use an appraiser who provided a lower than expected valuation on a previous engagement

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