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REAL ESTATE APPRAISAL PRACTICES

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REAL ESTATE APPRAISAL PRACTICES

CONTENTS

	Page
I. - INTRODUCTION.....	1
Three Basic Problems of this Report.....	1
II. - IMPORTANCE OF APPRAISALS TO THE CONSTRUCTION INDUSTRY....	2
Economic Soundness.....	2
Role of Appraiser in the Construction Industry.....	3
III. - THREE BASIC TESTS OF VALUE.....	4
Cost of Construction.....	4
Market Prices.....	5
Earning Capacity.....	6
Importance of Earning Capacity.....	6
Applicability of Earnings Method to Construction Projects.....	7
All Methods Correct Under Ideal Circumstances.....	8
IV. - SUMMARY OF CURRENT APPRAISAL PROCEDURE.....	9
No Written Data Employed.....	9
Limited Data Employed.....	10
Data Fairly Complete and Carefully Checked.....	12
Complete Data With Elaborate Reports.....	12
V. - WEAKNESSES IN CURRENT APPRAISAL METHODS.....	14
Reliance Upon "Common Sense".....	14
Faulty Theories of Value.....	14
Inadequate Data.....	15
Incommensurable Factors.....	15
Summation Appraisals.....	15
Other Weaknesses.....	15
VI. - RECOMMENDATIONS FOR IMPROVING CURRENT APPRAISAL METHODS AND PROCEDURE.....	17
More Adequate Data.....	17
Research on Basic Trends.....	17
Better Qualifications for Appraisers.....	17
Qualifications of a Competent Appraiser.....	18
LIST OF REFERENCES.....	19

EXHIBITS

EXHIBIT 1. - A typical unsupported certificate of appraisal.....	10
EXHIBIT 2. - A typical form of certificate of appraisal based on limited data.....	11

REAL ESTATE APPRAISAL PRACTICES

I.--INTRODUCTION

During the past decade the construction industry climbed to an unprecedented volume (in 1928), and then tobogganed to the smallest volume in recent years in 1931, with the decline continuing into 1932.* Accompanying this acrobatic behavior of the construction curve, we find an equally unprecedented volume of defaults, foreclosures, receiverships, demoralization in real estate securities, bankruptcies, unemployment, rent declines and building vacancies.

To what extent these distressing experiences might have been avoided, and if so, by what means, are outstanding questions engaging the attention of the construction industry.

Three Basic Problems of this Report

Attention is directed at the outset to three major problems involved in this report. These are:

1. To point out the extent to which the welfare of the construction industry is dependent upon appraisals (Section II of this report).
2. To set forth the distinctions between real and false appraisals (Sections III, IV and V of this report).
3. To suggest means by which those who bear the responsibility of financing the construction industry may bring about a more dependable type of appraisal service (Section VI of this report).

*According to the F. W. Dodge Corporation, contracts awarded in 37 states increased to \$6,628,300,000 in 1928 and then dropped to \$3,092,900,000 in 1931.

II.-IMPORTANCE OF APPRAISALS TO THE CONSTRUCTION INDUSTRY

While engineering genius has developed a technique which enables it to erect physically safe structures towering to more than one hundred stories, the economic soundness of many construction projects has been scrutinized with far less concern by those who were financially responsible for them. The result has been an unparalleled number of financial crashes resulting in staggering losses to many thousands of investors. While these tragedies can not all be attributed to unsound appraisals, there is a growing volume of evidence that the owners of many of these ill-fated projects relied for their security upon a species of guesswork masquerading under the name of appraising, which is no more entitled to that designation than a counterfeit bill is to be considered lawful currency.

Economic Soundness

The term "economic soundness" as here employed has reference to the capacity of a property or building project to fully pay for itself with interest during its economic life. Unlike physical soundness, economic soundness does not depend wholly upon factors within the physical limits of the property but depends to a large extent upon outside, surrounding influences and future developments. Economic soundness depends upon the type of improvement, the location, the demand for the type of property in question, the character of the management under which the property is operated, the volume of existing or potential competition to which it is exposed, and other similar factors.

An admirably designed and well-constructed office building, for example, would be an ill-advised project for a site adapted primarily to hotel or apartment development, and this fact should be clearly shown by competent appraisers. Similarly, a new apartment-hotel, consisting of small residential units, would be economically unsound in a neighborhood in which vacancies in similar properties are already numerous or in which prospective developments of similar projects may result in excessive competition with consequent falling rentals, an increasing percentage of vacancies, or both.

These examples illustrate the relationship of a thorough appraisal service to the construction industry and demonstrate the fallacy in the assumption frequently made, sometimes by so-called appraisers, that all the factors governing the value of a property are confined within its four walls. Consequently we are warranted in advancing the opinion that a vast number of ill-advised building projects would never have gone beyond the blue-print stage had these projects been subjected to thorough analyses by competent appraisers, because such analyses would

inevitably have disclosed their unsoundness as bases for the loans which were made to finance them. A sound appraisal should be the very keystone in the plan of every construction project, since the financial success or failure of the project will depend upon its economic soundness.

Role of Appraiser in the Construction Industry

The highly responsible role of the appraiser in the construction industry can be clearly set forth by defining the primary duties or functions of an appraiser, which are:

1. To properly analyze all factors affecting the value of the property to be appraised;
2. To estimate the probable economic or profitable life of the property;
3. To correctly compute the value of the property as of a given date; and
4. To present in his report sufficient evidence supporting his conclusions to enable those financially interested in the property to act with safety.

III.-THREE BASIC TESTS OF VALUE

In order that those who have occasion to employ the services of an appraiser may be able more readily to distinguish between genuine and counterfeit appraisals, it may be helpful to summarize briefly the basic tests of value employed in all types of valuation work.

There are only three basic tests of economic value which an appraiser can employ in appraising a given property. He may base his valuation upon (a) the cost of production of the property, including both land and improvements; (b) the prevailing market prices of similar properties; and (c) the expected earning capacity of the property. Many appraisers have in the past chosen one or another of these three tests as the primary one. As a result we have what may be termed three distinct schools of appraisal thought based upon these three fundamental tests of value. A fourth school might be mentioned which recognizes none of these three tests as final and conclusive but employs all three in estimating the value of a given property.

Cost of Construction

The First basic test of value is founded upon the theory that the value of any property is determined by its cost of construction or reconstruction, minus an allowance for depreciation or obsolescence. Adherents to this method consider that no one is better qualified to appraise a property than a builder or contractor, since he is able to most accurately compute the cost of the physical components of the property, and they support their position on an old economic generalization that the value of reproducible goods in the long run tends to be equal to their cost of production.

While this may at first thought seem to be the most plausible method of determining property values, a slight amount of reflection will disclose grave weaknesses in this line of reasoning. Among these we may mention first the fact that it neglects the highly important factor of the suitability of a given improvement to its location. According to this theory a residence, apart from its ground value, would have the same value on a downtown business site as it would in a suburban location or in the country, and a commercial hotel located in a desert would have the same value as if it were in the heart of a metropolitan center. This rule also ignores fluctuations in market prices and entirely omits consideration of the property's earning capacity as if this were of no consequence. Furthermore, according to this principle, a building which is only ten per cent occupied would be appraised at the same value as a similar structure more

favorably situated which is ninety per cent occupied. Similarly, this principle does not take into account the fact that many structures are so situated that they may be subjected to veritable blizzards of competition which may develop as a result of overbuilding, ruining property owners and investors alike, even though the properties involved would, if appraised according to their cost of construction alone, represent sound values and secure investments.

In fairness to the cost method of estimating property values it should be said, however, that this test furnishes a means of fixing a fairly accurate maximum limit on building values, because a building cannot ordinarily be worth more than would be the cost of replacing it with a similar structure. In the event, therefore, that another method points to a higher figure than that represented by cost of replacement minus a reasonable allowance for depreciation and/or obsolescence, the cost method furnishes conclusive evidence that there is some flaw in any other method that leads to a higher apparent value.

Market Prices

The second school of thought, representing what we may term the market value group, attempts to base its appraisals primarily upon the prevailing market prices of similar properties.

The most serious fault of this method is the difficulty of finding sales of strictly comparable properties upon which to base a fair estimate of the value of a given property. Due to the comparatively large number of sales of houses and lots of all types, there is less difficulty in applying this rule to residential properties or to vacant parcels of land than to large store or office buildings, but even in the case of residences or vacant land it is impossible to find exactly comparable properties, so that at best this method serves only as a rough guide in estimating individual property values. Another fault of this method arises from the difficulty of securing correct selling prices, as they are frequently disguised or erroneously reported; but even granting that the real prices paid are known, it does not follow that these either prove or represent real values. Personal situations on both the buyers' and the sellers' sides frequently result in sales above and below true values, and in times of booms and depressions real estate prices in entire communities depart from sound values by very wide margins. Consequently, selling prices can at best be employed only as aids in determining real values but cannot be relied upon as a conclusive test of the sound value of any given property.

Again it may be said, however, that if market prices of certain types of properties are collected in sufficient numbers and over suf-

ficiently long periods to reflect market trends, these data may be employed as a standard by which to approximate values by comparing a given property with the selling prices of a representative number of similar properties. Hence this method affords an effective means of checking the values of properties such as houses and lots, in communities where a sufficient number of sales of comparable properties have taken place to afford satisfactory samples.

Earning Capacity

The third basic test of value depends upon the expected net earning capacity of the property. Consequently this method is restricted to properties which yield a cash return or involve benefits to their owners that can be measured in terms of money, which may then be converted into a capital sum representing the value of the property by a process known as "Capitalization." This is merely the technical name for a method of determining the amount of money which a purchaser would be warranted in paying for a property from which he desires to realize a certain rate of return upon his investment.

Like the cost method and the market price method discussed above, the earning capacity method also has its handicaps. First of all there is the task of determining the income and operating factors with sufficient accuracy to compute an accurate current net yield. The next and still more difficult factor to be determined is the probable future trend of cost and income factors and the consequent uncertainty in accurately estimating what the prospective net earnings will be and how long the useful or profitable life of the property may continue. While, from the point of view of the investor, this is a factor of paramount importance, it is impossible to foresee all of the still non-existing factors which may arise and which may completely change the economic picture visible at the time the appraisal is made. Consequently, it must in all fairness be said that while this method of appraising income properties is theoretically unassailable, it is encumbered with important difficulties which arise from the hazards incident to an accurate prediction of future earnings.

Importance of Earning Capacity

In the final analysis, however, the value of any income property depends solely upon the return which it will yield, and hence no appraiser is warranted in making an appraisal which represents the value of any income or investment property as being in excess of the present worth of the net earnings which it may reasonably be expected to yield during its remaining economic life. The principal limitation of this method lies in the fact that it is not readily applicable to houses, factories, and other properties that do not have clearly ascertainable net earnings measurable in terms of money.

The outstanding and primary reason for making an appraisal of an investment property for loan purposes is to determine its capacity to yield a return sufficient to justify the investment in the property, since no investment in a property is warranted which will not be fully repaid with interest. Appraisals for investment properties should indicate clearly the volume of earnings above taxes and operating charges that will be available to discharge principal and interest payments. To lenders, therefore, net earnings represent a factor of even greater importance than the appraised valuation of the property, which they do not desire to purchase, to sell or to own.

Equally important from the lender's point of view is the probable duration of net earnings. A property such as a small store and office building, or a small apartment building, may yield a net return of \$5,000 per annum at the time it is appraised. If, however, an investor were to make a long-term loan upon these properties on the assumption that this volume of net earnings would continue during the term of the mortgage, he would be practically certain to find his loan in distress if, at the end of three or five years, net earnings had fallen to one-half of their original volume. Since the volume and duration of the net earning capacity of the property is the primary concern of lenders on all types of income properties, these two factors are of greater importance to investors than the final appraised value of the property.

Applicability of Earnings Method to Construction Projects

It is frequently argued that in the case of construction projects which are still to be built, the income method of appraising is impracticable because there are no earnings upon which to base such an analysis. The same argument, however, would preclude the possibility of designing or even considering such projects since the promoters are, as a rule, interested in them solely from the point of view of the return which their investment will yield. Consequently, it is clearly within the province of an appraiser to offer a solution of this problem on the basis of projected plans and specifications.

The argument is frequently advanced that appraisals for conservative first mortgage loans may be different from appraisals made for such purposes as condemnation, junior financing, and sale or settlement of an estate. From the point of view of a thorough and competent appraisal this line of reasoning is no more logical than it would be for a physician to make a different diagnosis of a case of appendicitis, depending upon the occupation of the patient. As far as the appraisal is concerned, the purpose for which it is desired should make no difference except that in reporting the result of his analysis an appraiser may place more emphasis on particular factors if he is familiar with the specific purpose for which the appraisal is made.

All Methods Correct Under Ideal Circumstances

The foregoing criticisms of the three basic tests of value are not intended to discredit the possibility of making a sound appraisal, but rather to show that there is no simple formula applicable to all cases, and that the best appraisers can make a trustworthy valuation only after careful study and analysis of all factors pertaining to the particular property under consideration, including probable changes in market prices, rentals, building costs, changes in uses of properties, growth and movements of population, and other basic factors.

The fact may here be noted that under ideal conditions all three of these methods would theoretically produce the same result. In other words, an income property correctly designed, properly located and perfectly constructed should, under normal economic conditions, yield a return fully commensurate with the investment in the property, and its market value should be equal to its full normal cost of construction. The appraiser has no right to assume, however, that anything about the property is ideal, and consequently he is as much responsible for pointing out and weighing factors which detract from the value of the property as he is for crediting the property with those factors which contribute to its value.

IV.-SUMMARY OF CURRENT APPRAISAL PROCEDURE

There is a bewildering variety in the actual appraisal procedures followed by appraisers today. However, a partially completed study of the practices adopted by insurance companies, investment bankers, savings banks, commercial banks, trust companies, building and loan associations, appraisal companies and real estate boards has led to four general classifications as to the degree of completeness in the method of procedure and the resulting reports. These classifications are:

1. The unsupported statement of the appraiser or an appraisal group as to its opinion of the value of the property.
2. Limited data collected or verified by appraisers used as the basis for the same type of report as in class 1.
3. Considerable written data obtained by the appraiser and some method by which the appraiser's work is reviewed.
4. A detailed report analyzing the property from every angle in accordance with the better scientific principles.

No Written Data Employed

In the first type of procedure, which unfortunately is still widely practiced, we find a document purporting to be a certificate of appraisal or in some cases a less formal paper or letter which is subscribed to by from one to three individuals as appraisers. There is no evidence of any written material gathered in support of the valuation figure. The "appraisal" merely sets forth the opinion of the signatars as to the value of the property.

A certificate typical of this class is shown in Exhibit 1.

Certificate of Appraisal

Date _____

To: _____

We, the undersigned, being duly appointed for the purpose, by the (institution) issuing this certificate, hereby certify that we have carefully considered the application for an appraisal of the property described herein; that we have personally examined said premises; that we have no personal interest in the property, and in our opinion said property is worth:

Land \$ _____
Improvements \$ _____
Total \$ _____

Committee: (_____

_____)

(Seal)

Exhibit 1.-A typical unsupported certificate of appraisal.

Among the conditions sometimes appended to such an appraisal are phrases to the effect that the description, income and such special data upon the property as are submitted by the applicant are assumed by the committee to be correct; that no responsibility is assumed by the committee; and that title is assumed to be good.

Limited Data Employed

The second general classification embodies a procedure of a slightly higher degree of development, requiring a somewhat systematic gathering of certain basic facts in writing to serve as a foundation for the valuation of the property.

The form shown in Exhibit 2, which is executed by the valuation committee, is typical of this method.

Valuation Committee's Report

of (name of loaning institution).

City _____ 19____

Property of _____

Location: No. _____ Street _____ side

Between _____

_____ lot _____ in Square _____ No. _____

Front, _____ Feet; rear, _____ feet; depth, _____ feet; contains _____

_____ square feet. _____ footway in front; has _____ alley

_____ feet wide on the _____ of lot. Street is _____ graded.

_____ pavement. _____ sewerage.

Improvements: _____

Assessed in the name of-- _____

Assessment value:

Lot _____ Sq. _____, _____ Sq. Ft. at _____ \$ _____

Improvements: _____

Total - - - - - \$ _____

We estimate the present value of the improvements in this location, _____ \$ _____

Lot _____ per foot, _____ \$ _____

Total - - - - - \$ _____

Valuation Committee (_____)
(_____)
(_____)

(Seal) _____

In some instances each member of the committee may be supplied with a copy of the applicant's detailed description and be required to make his inspection alone, checking carefully the applicant's statements. The members meet later and determine what the valuation shall be. While the effectiveness of this method as generally used by certain loaning institutions is based upon serious personal attention of the appraisers employed, it is classified in the second group because of the limited amount of data gathered in making an appraisal and the informal character of the appraisal report.

Data Fairly Complete and Carefully Checked

In the third classification we find appraisals which show a marked degree of improvement over those encountered in groups one and two. The appraising personnel in this category is generally more experienced or equipped with a better background than the average appraiser. Also there is usually more or less of a system in operation involving the use of standard work-sheets by the inspectors and requiring a statement in writing indicating the reasons for the valuation. At a certain stage prior to the final approval of the valuation, a competent group of individuals may review the work of the appraisers to determine the reasonableness of the valuation. In arriving at a figure both the appraisers and the reviewers usually have access to files of appraisal data which may be applied in addition to that gathered.

An example of appraisal procedure falling within this class is furnished by the practice of an institution making real estate loans throughout the country. This company establishes local correspondents to appraise property and recommend loans in that community. The company also employs regional supervisors (twelve in number) who visit the correspondents in their respective regions and in addition actually inspect the various properties. Two or three general supervisors are retained to check the regional supervisors. The local correspondents are bound further by contracts to the effect that they will assume the loan if the security (appraised property) is unsatisfactory to the central organization. Before the final approval of an application, the appraisal department of the main office makes a careful technical examination.

Procedures of this third group are probably the most effective of the generally practiced methods.

Complete Data With Elaborate Reports

Classification four, representing the highest degree of scientifically developed appraising, is used comparatively little, though it is gradually becoming more widely recognized.

It consists first of a careful study of the entire problem by exceptionally well qualified experts who, after compiling the necessary field data on carefully prepared work-sheets, turn to their "work shops" where they compute the valuation and prepare the report. At the "work shop" one finds an up-to-date file of appraisal references and data and experienced co-workers with whom various points may be discussed.

One sample appraisal of this type consisted of a first page as a certificate of appraisal with the remaining seventeen pages dealing with the data and explanations in support of the valuation. Among the items discussed are: the location of the property, to which a page of discussion was devoted; data covering transportation facilities (1 page); legal description of the land; description of the improvements with a tabular analysis of the kinds of rooms and floor space; the valuation process (3 pages); tabulation as to income; operating cost and expense; and other important elements essential to proper appraising.

This latter practice undoubtedly results in a figure nearest to an accurate valuation of the property partly because of the methods employed and partly because the original object is to find the real value, whereas the other methods are utilized principally by institutions whose primary concern is in the fact that the appraisal figure shall not exceed the real value of the property. The point should be stressed, however, that appraisals made on the basis of "playing safe" from the lender's point of view are unfair to the owner, just as excessive appraisals reverse these interests. Fairness to all parties concerned demands that appraisals be accurate and made without bias in favor of either lenders or borrowers, buyers or sellers.

V.-WEAKNESSES IN CURRENT APPRAISAL METHODS

While the appraisal profession has made very commendable progress during the past decade, there are still many appraisers who regard the emphasis which is being placed upon adequate data and correct principles as if they were nothing more than showy window dressing.

While those who fail to consider definitely formulated principles and technique may frequently be right in their conclusions, one of their principal weaknesses lies in the fact that under changing conditions there is danger of their falling into error due to a lack of technique for weighing and measuring changing factors. But perhaps the greatest fault in such procedure lies in the ease with which it may be imitated by wholly incompetent and untrustworthy appraisers, since the only requirement upon them is their signature to a sheet of paper stating that, in their opinion, a certain sum represents the value of the property.

Reliance upon "Common Sense"

The foregoing remarks should not be construed as relegating to the scrap-heap the vitally important factor of common sense in appraising. On the contrary it is assumed that true common sense must be the very essence of good appraising, and that it will serve in the field of appraising just as it does in engineering or other fields. No amount of theoretical procedure can make an appraisal satisfactory without good judgment and the application of sound common sense. Sound judgment, proper data and correct principles are all equally necessary in making a true appraisal and the proper application of all three is the only adequate insurance against counterfeit appraising done by those who are deficient in any or all of these essentials, but who conceal their faults under the pretence of "common sense."

Faulty Theories of Value

Another group of appraisers which has led many investors in financial institutions astray includes those who embrace faulty theories of value. While the subject of value constitutes one of the most technical concepts in economics and has been ably expounded in numerous court decisions and voluminous treatises, there are still many who call themselves appraisers who have invented their own amateur theories, apparently unaware of the fact that the subject has been given extensive thought by many able minds over a long period of years.

Again we find another group which adheres tenaciously to simply one of the three basic tests of value described earlier in this report, ignoring the limitations and shortcomings inherent in each of these tests, which have already been indicated.

Inadequate Data

Another weakness of many appraisals lies in the fact that known or ascertainable data have been improperly or inadequately used. Many an appraiser points with pride to the photographs attached to his appraisals, the market price data carefully entered upon a plat book of the city and figures on costs of various types of construction, but can furnish no information relative to such vital matters as rentals, operating costs or net yields of investment properties in the community. While elaborate and complicated appraisal forms may not be necessary, there are certain essential data without which a proper appraisal analysis is impossible, and which should form the basis of every properly substantiated appraisal.

Incommensurable Factors

There are other limitations in current appraisal methods which are due largely to the influence of immeasurable factors which comprise the twilight zone of speculative considerations. Such factors as the influence of skyscraper construction, the effects of rapid transit development, automobile transportation, and industrial decentralization have an unquestionable influence upon property values; but their measurement presents difficulties which the appraisal profession so far has not solved with a gratifying degree of success.

Summation Appraisals

Frequently separate appraisals are made of the land (or leasehold) and the improvements, which then are added to obtain the value of the entire property. The worst results of this method grow out of a practice sometimes employed of having such parts of properties appraised by different appraisers, and adding the figures obtained from each to represent the total value of the property.

This practice is condemned as unsound, inaccurate and misleading because it disregards the effect of over, under, or misplaced improvement. In the case of investment properties it evades the fundamental question of the economic soundness of the improvement and disregards the interrelation between land (or leasehold) value and the value of the improvement.

Other Weaknesses

The most inexcusable weakness in current appraisal practices are: (a) failure on the part of appraisers to keep abreast of the

appraisal technique employed by the more competent appraisers throughout the country, and (b) allowing anyone to represent himself as an appraiser who consciously or fraudulently misrepresents property values for the purpose of collecting a fee for his services.

VI.-RECOMMENDATIONS FOR IMPROVING CURRENT APPRAISAL METHODS AND PROCEDURE

More Adequate Data

Doubtless the greatest handicap experienced by all appraisers at the present time is the lack of adequate real estate data. Information reflecting the current demand and supply of various classes of properties, rentals, market prices, operating costs, and construction costs are exceedingly meager, and as a rule appraisers desiring to employ such information are compelled to assemble it themselves. It is strongly urged that suitable agencies for compiling information of this type be encouraged not merely for the purpose of supplying such information currently, but also to serve the equally important purpose of providing a basis for determining the trends of each of the above-mentioned factors.

Research on Basic Trends

Another field of inquiry deserving of considerable research is the study of trends in land uses and the consequent effects as reflected in trends of site values.

While considerable work has been done by the Bureau of Internal Revenue, The National Association of Real Estate Boards and others in estimating the economic life of real estate improvements, this subject is also recommended for further research.

Better Qualifications for Appraisers

Another vital improvement in appraisal methods may be hoped for through the establishment of better qualifications for appraisers by some agency such as the American Institute of Real Estate Appraisers, which has recently been organized by the Appraisal Division of the National Association of Real Estate Boards. In addition to refining the standards of appraisal practice, such an organization could also periodically disseminate information with reference to the entire field of appraising and could exercise a wholesome supervisory power over its membership through the medium of properly drawn membership requirements. Such an organization could, moreover, go far toward fixing a degree of responsibility upon appraisers for making erroneous and faulty appraisals.

It is further suggested that the establishment of fuller information in public records regarding real estate, additional research by educational institutions and foundations with reference to the more basic problems concerning the great dynamic movements which are taking place in the real estate field, and more detailed studies

involving the practical application of the fundamental principles of real estate values, would be of great value to appraisal practice.

Qualifications of a Competent Appraiser

Worthy efforts are being made to raise the standards of the appraisal field to those of a true profession, through courses in real estate appraising which are now offered in many colleges, universities and other organizations, through research activities and publications in the appraisal field, and through the formation of a professional society of appraisers, such as the American Institute of Real Estate Appraisers previously mentioned.

The cooperation of those requiring the services of an appraiser is urged to aid in bringing about a more competent type of appraisal service by choosing appraisers who are properly qualified to render a trustworthy service. Among the qualifications which every appraiser should possess are:

1. Honesty.
2. Sound judgment.
3. Knowledge of the principles and technique of appraising acquired through study and experience.
4. Knowledge of the uses of the types of properties to be appraised.
5. Knowledge of rentals paid for the types of properties to be appraised.
6. Knowledge of the operating costs involved in the types of properties to be appraised.
7. Knowledge of the cost of construction, replacement, or remodeling of the types of properties to be appraised.
8. Knowledge of financing terms and prices paid for properties similar to those to be appraised.
9. Ability to take a long-time view of considerations which must be weighed and analyzed in appraisal work, particularly those which affect the future net income yielding power of the property.
10. Willingness to learn and the habit of keeping abreast of the best standards and practices in the appraisal field.

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