Extraordinary Assumptions and Hypothetical Conditions

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In the course of reviewing appraisals, most of us go straight to the value conclusion and then probably to the approaches to value. The last thing we want to read is a bunch of legalese, such as limiting conditions and assumptions.

All appraisal reports contain standard qualifiers that often appear in a section called "General Limiting Conditions and Assumptions." These items are worth reading now and then, but they're usually the same from report to report. Also, they usually have no significant effect on value.

However, *extraordinary assumptions* and *hypothetical conditions* are very important and can have a significant effect on value. It's important to read these items carefully to understand how they pertain to the value conclusions in the appraisal report.

The Uniform Standards of Professional Appraisal Practice (USPAP) defines an *extraordinary assumption* as "an assumption, directly related to a specific assignment, which, if found to be false, could alter the appraiser's opinions or conclusions." A *hypothetical condition* is defined as "that which is contrary to what exists, but is supposed for the purpose of analysis."

USPAP requires appraisers to clearly and conspicuously state in their appraisal reports any extraordinary assumptions or hypothetical conditions necessary in an assignment. The report must also state that their use may have affected the assignment results.

Real-World Examples

An example of an extraordinary assumption would be appraising a gas station as if it were free and clear of environmental contamination when it's not known to be contaminated. A hypothetical condition for an appraisal of the same gas station would involve appraising the property as if it were free and clear of environmental contamination when it is known to be contaminated.

FIRREA requires an appraisal report to include market value "as is" of the real estate only. Specifically, an appraisal is to include the current *market value* of a property in its actual physical condition and subject to the zoning in effect as of the appraisal date. This requirement essentially eliminates the use of extraordinary assumptions or hypothetical conditions when valuing the real estate collateral "as is."

This author encountered a real-world example recently when reviewing an appraisal of an industrial building with groundwater and soil contamination. Typically, an appraisal report will contain a hypothetical condition that the site is not contaminated and provide the market value as is. This conflicts with the fact that the subject property is physically contaminated and thus market value "as is" should account for the contamination.

The appraisal valued the property at $2.6 million without consideration of contamination. As noted above, it's common for most appraisers to stop at this point and call this market value "as is" and present a hypothetical condition stating no contamination was considered. However, in this case it was estimated that remediation to clean up the site would cost about $300,000. Also, the market was placing a 10% stigma on this property for being contaminated. Deducting these items resulted in a true market value "as is" of $2.1 million, rounded. The $500,000 difference in value is important when calculating loan losses, reserves, impairment, and so forth.

Another common hypothetical condition this author saw in the bubble years of 2005 to 2008 was an appraisal for a property as if the zoning had changed. For example, a property was currently zoned for agricultural use, but in the very near future the zoning was to change to residential. The appraiser would assume this event would definitely occur and appraise the property under the new zoning.

A 20-acre site that was to be rezoned to allow a 200-unit apartment complex was appraised at $10,000 per unit, or $2 million. When the economic crisis occurred, the zoning change was abandoned and the property remained a 20-acre tract of agricultural land. At $10,000 per acre, this property was worth $200,000 and would probably appraise at that level (or even lower) today. This is a common explanation for why a property appraises substantially lower today than it did two to four years ago. Upon reviewing the original appraisal, you will often find an extraordinary assumption or hypothetical condition that went along with the value indication.

A number of banks will not accept hypothetical conditions in their appraisals. While it's unclear if that should be a line in the sand, the point is that there is recognition that a hypothetical condition (or extraordinary assumption) means that the indicated value is not representative of the actual collateral today.

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In summary, the message here is not to avoid ordering or accepting an appraisal with extraordinary assumptions or hypothetical conditions. In many situations, these assumptions and conditions are needed to make an informed credit or workout decision. The suggestion is to look for these items and see if you can determine how they affect value. If you can't make that determination, ask the appraiser to explain what would happen to the value indication if the assumptions or conditions were not used. As noted above, values can vary significantly, and these items might be the explanation you're looking for. ❖

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