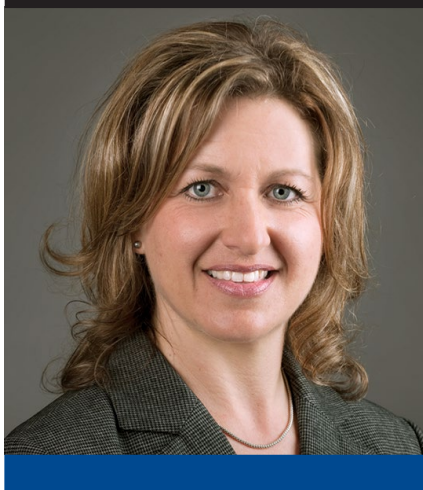




# WORTH KNOWING

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## The cost approach

### 0912 AIC Residential Full Form

In 2013, the Appraisal Institute of Canada (AIC) released an updated version (0912) of the Residential Full Form. The update included a number of changes, one of which was moving the cost approach from a small box above the direct comparison approach to its own dedicated page. The previous format made it difficult for the appraiser to expand on costing, and to provide a detailed breakdown and sufficient commentary for the reader to understand the analysis. As part of the redesign, each valuation methodology was given its own page, allowing the appraiser to select the methodology(ies) that are relevant to the assignment.

This is simply a change in formatting and form design and does not imply that the cost approach has been removed as a valuation methodology. The cost approach continues to be one of three valuation methodologies recognized under the *Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP)* and as part of the teachings. It is up to the appraiser to determine the relevance of the valuation methodologies in the context of an assignment and which one(s) apply. Under *Appraisal Standard Rule 6.2.16*, in the report, the appraiser must describe and apply the appraisal procedures relevant to the assignment and support the reason for the exclusion of any of the usual valuation procedures (see *Appraisal Standard Comment 7.17* for additional compulsory requirements).

## A cost-to-complete is not a progress inspection report

Some lenders ask that the appraiser provide the cost to complete a new construction or renovations on their form or a specific format. The issue with some of these forms is that they do not include all of the critical construction elements, nor are they *CUSPAP* compliant, and they cannot be properly completed without AIC's comprehensive progress inspection report that also includes key assumptions and limiting conditions and a proper certification.

AIC's progress inspection report includes three stages broken down into greater detail by key items. The breakdown is considered to reflect typical construction of residential dwellings (recognizing that more unique, custom built or other designs may warrant slight variations of the breakdown).

Since the estimate of value in the appraisal report is as at an effective date, the cost-to-complete can only be determined as at that date. In order to provide the estimated cost-to-complete post-effective date, the appraiser will be required to reassess the estimate of value, which becomes a second assignment. Construction costs are not static and, in heated markets or where there is shortage of skills, construction costs (i.e., material, labour charges, delays) can increase significantly and in a short period of time. As a result, the cost-to-complete estimated with the original report could change as the work progresses.

Under *CUSPAP*, a progress inspection report as part of or as a follow up to an original appraisal report is an appraisal assignment. A standalone progress report (without an original



appraisal report) is a consulting assignment, since no estimate of value is provided. The AIC continues to work with intended users to encourage them to align their forms with or adopt AIC's progress inspection report.

## The income approach

### A market rent estimate is an appraisal assignment

Some lenders request that the appraiser provide an estimate of the market rent of a property, either as part of an appraisal or as a standalone assignment. Income schedules, schedule As, and letters with opinions of market value cannot be produced as standalone documents, since they are not recognized report formats under *CUSPAP*. The appraiser has an obligation to provide the estimate of value in accordance with the Rules and Comments of the Appraisal Standard, which also includes a Certification of Value.

Providing rental information on comparable properties as a market analysis assignment is a consulting assignment, estimating the market rent of the subject property falls under the Appraisal Standard. *Consulting Standard Comment 11.1.2* states that, if a formal opinion of value on an identifiable property is required within the consulting assignment, that portion of the consulting report must be developed under the Appraisal Standard.

## Letters – getting it in writing

### Letter of opinion

*CUSPAP* recognizes three types of reports: the residential form report, the short narrative and the full narrative. A letter of opinion is not an acceptable reporting format and is therefore not covered under AIC's professional liability insurance program. Opinions and opinions of value must be developed in compliance with the minimum content requirements stipulated within the Rules and Comments of the relevant Standard under the appropriate reporting format.

### Letter of engagement

Letters of engagement have long been a part of the fee appraisal practice, but have often been limited to major or non-residential assignments or initiated by the client. Such letters are undoubtedly of assistance in ensuring a clear understanding between the practitioner and

the client as to fee structure, invoicing and terms of payment, scope of assignment, purpose and intended use of the report, data to be provided by the client, timelines and deliverables, and other assignment specific information. By maximizing the level of understanding between the appraiser and the client, the engagement letter acts as a contract and can also serve as an important claims prevention tool.

The *Professional Excellence Bulletin* entitled 'Letter of Engagement' available at (<http://www.aicanada.ca/professional-liability/professional-excellence-bulletins/>) as well as *Practice Note 14.10.5* in *CUSPAP* provide guidance on content and some of the key areas to be addressed in a letter of engagement.

In situations where a client provides the letter of engagement, the appraiser should take care to ensure that all terms to be agreed to conform to the appropriate standards of professional practice. The appraiser would also be prudent to add an addendum to the letter if necessary to detail any terms not spelled out in the client's agreement.

The goal is to avoid surprises and misunderstandings on the part of the client and the appraiser before the assignment is undertaken. The most comprehensive letter of engagement cannot remove the appraiser's obligation to perform the assignment in accordance with the applicable standards of professional practice, but certainly serve as an important step in the appraisal/valuation process.

### Reliance letter

Appraisers are frequently asked to authorize the use of a report by an unintended third party, i.e., a party other than the one(s) intended for the original report. This most often takes the form of a lender requesting authorization to use the appraisal for underwriting purposes, when the report had originally been prepared for the owner and/or a different lender. However, there are a vast number of other permutations of uses and users beyond those intended at the time of the assignment. A report transferred to a third party continues to carry with it the pre-existing ability to attract a

claim. By formally acknowledging the right of a third party to rely on the report, you will be extending the right to make a claim as a result of reliance on the report as well as opening up additional possibilities for a claim from the original client, such as a breach of confidentiality. Per *Appraisal Standard Comment 7.2*, the intended user must be identified by name and the practitioner should be cautious where the intended user name is vague or when there are multiple users. *Practice Note 14.13* provides examples of acceptable and unacceptable intended user references.

In general terms, the practitioner can permit the use of a report by an unintended third party, however, it is important to ensure that this new party is made aware of the dates associated with the original report to ensure that the value, opinion or conclusion only applies as of the effective date, any special considerations and assumptions, client terms of reference, etc., that entered into the value conclusion. Although these would be expected to be detailed in the report, there may be assumptions based on discussions with the original client (or others) that are not fully explained in the report. A good practice would be to also note them in the reliance letter.

The older a report, the less relevant it will be to a third party and it is not unreasonable for the practitioner to judge the relevancy of the report based on the circumstances at hand and decline authorization. It should be clear to the prospective user that there may have been significant changes to the property, market conditions or other since the time of report that would have a material impact on the conclusion.

When faced with a request to assist the third party, the appraiser has the choice of writing a reliance letter, completing a new report for the new intended user (provided the appraiser is not in a conflict of interest), or declining to authorize reliance by a third party.

*Practice Note 14.13* in *CUSPAP 2014* has a comprehensive sample reliance letter that members can copy and paste and customize as required and *Professional Excellence Bulletin* entitled 'Authorizing Reports for Use by Third Parties (Reliance Letters)' available at (<http://www.aicanada.ca/professional-liability/professional-excellence-bulletins/>) also discusses best practices. 