Introduction

USPAP Standards Rule 1-2(c) requires that for opinions of market value the appraiser “ascertain whether the value is to be the most probable price: in terms of cash; or in terms of financial arrangements equivalent to cash; or in other precisely defined terms.” USPAP Standards Rule 1-2(c)(iv) further requires that “if the opinion of value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified and the appraiser’s opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.”
The definition of presumed mortgage conditions is an explicit or implicit instruction of the appraiser’s client. The instruction may mirror a loan commitment or only sought conditions. The presumed financing may be prospective or existing. There may be more than one presumed mortgage. Components of financing include the amount of the mortgage loan(s), its interest rate(s), its interest payment interval(s), its schedule(s) of debt repayment, required fees for placing the loan(s), and required restrictions or fees for early termination of the loan(s). Any of the components can diminish or enhance market value.

An opinion of market value may presume “all cash,” meaning no financing, i.e., that the real estate is debt free at the time ownership is transferred. More likely, the presumption will be “all cash to the seller,” meaning the buyer mortgages the real estate as security to a third-party lender who pays part or all of the price in cash; if the financing is part of the price, the non-mortgaged amount is paid in cash by the buyer. In some cases the presumption will be that the seller will partially or entirely finance the purchase, i.e., will “hold paper,” meaning take back the buyer’s purchase-money mortgage. This could be instead of or in addition to a third-party loan.

Each comparable transaction, the financing of which differs from that presumed for the appraised property, should be adjusted to parity. For example, assume that the property is to be appraised presuming an 80%, self-amortizing, 300-month, 0.677% monthly interest rate loan available to a qualified borrower for the pre-payment of three percent of the loan amount (three placement points). If the loan conditions for one of the comparable sales were identical in each respect except that four placement points were paid, an 0.8% (one point times 80%) increase in the price of that comparable would accommodate its financing difference.

Appraisers, when calculating financing adjustments, often substitute the expected remaining loan term until a logical refinancing date for the longer total loan term.

Many appraisers find it an orderly process to first adjust and analyze each comparable price to its arithmetic equivalent of an all-cash-to-the-seller price. Then, if necessary, they adjust the cash-equivalent conclusion of the comparable prices to the presumed financing of the appraised property. Even when the presumed financing is other than cash-equivalent, this process is favored to reveal the quantified total effect of the financing. (The expression “cash equivalent” pertains to the seller’s point of view; a loan is not the true equivalent of cash to a purchaser who does not have the alternative of paying cash.)

When appraisers refer to “favorable financing,” they mean favorable to the buyer. Such financing may be unfavorable to the seller but often it is a matter of indifference to the seller.

When the value to be developed for the subject property is market value based on cash, or financing that is equivalent to cash, comparable sales used in the sales comparison approach must be analyzed and adjusted for financing that may have influenced their prices.

A client may request a market value opinion on the assumption that specific financing, other than cash-equivalent, is available. Or the client may request that the property be valued with existing financing. In such cases, the appraiser should be careful to use a market value definition that is consistent with such an assumption. Further, the appraiser must analyze the effect of such financing; it may have no effect on the resulting value, or it may have a favorable or an unfavorable effect.

In responding to the questions posed by the client that initiated the appraisal assignment, the appraiser must adhere to ethical standards and fundamental appraisal principles and practices that are applicable to the market. A clear understanding is necessary between the appraiser and the client as to the interest being valued and the need for the appraiser to analyze existing, available, and/or proposed financing. If the appraisal assignment is to develop an opinion of market value, the definition of market value must not only be consistent with the client’s needs but must also meet the requirements of USPAP Standards Rule 1-2(c) as quoted below in the next paragraph.
USPAP Standards Rule 1-2

(c) “identify the type and definition of value; and, if the value opinion to be developed is market value, ascertain whether the value is to be the most probable price:

(i) in terms of cash; or
(ii) in terms of financial arrangements equivalent to cash; or
(iii) in other precisely defined terms; and
(iv) if the opinion of value is to be based on non-market financing or financing with unusual conditions or incentives, the terms of such financing must be clearly identified and the appraiser’s opinion of their contributions to or negative influence on value must be developed by analysis of relevant market data.”

“Comment: When reasonable exposure time is a component of the definition for the value opinion being developed, the appraiser must also develop an opinion of reasonable exposure time linked to the value opinion.”

Basis for Proper Evaluation

The market value of a clearly identified property interest may be reported in a number of ways: 1) cash, 2) terms equivalent to cash, or 3) with other precisely defined terms. An example of such other terms is the cash value of the equity interest subject to existing or proposed financing.

USPAP Standards Rule 1-2(c) requires an appraiser to clearly define the terms of such financing and develop an opinion of their contributions to or negative influence on value. USPAP Standards Rules 2-2(a)(v) requires that, if the value opinion is market value, the report state whether it is “in terms of cash or of financing terms equivalent to cash, or based on non-market financing or financing with unusual conditions or incentives.” Further, if the opinion of “market value is not in terms of cash or based on financing terms equivalent to cash,” the report must “summarize the terms of such financing and explain their contributions to or negative influence on value.” The appraiser can either:

Report two values (as financed and cash-equivalent); or
Report one value and indicate the positive or negative influence the financing terms have on the value reported.

USPAP Standards Rule 1-2(c) contains this reporting requirement so that interested parties will be aware of how much the favorable or unfavorable financing impacts the value reported. USPAP Standards Rule 1-2(c) does not imply that different financing terms will always lead to a different value. It simply requires that a proper analysis be made.

Subject Analysis When Financing May Affect Value

When developing an opinion of the value of a property, the appraiser must ascertain whether or not any existing financing is assumable, retireable, or replaceable. Also, the appraiser must estimate the potential value impact of the cost items such as finder’s fees, points, and prepayment penalties and the effect of the present worth of participation by lenders, if any. The appraiser should also judge the duration of any favorable or unfavorable influence from mortgages or participations. It should not be assumed that the benefits or detriment due to financing will continue throughout the stated amortization or participation terms. The value impact of a mortgage fluctuates as interest rates rise and fall. The possibility of retiring unfavorable financing prior to its full payout period should also be considered.

Once a property owner finances the property, ownership may become subject to the terms of the mortgage. The sum of the value of owner equity and the face amount of the balance(s) of the mortgage note(s) may or may not be equal to the free and clear value of the property. Any difference represents the impact that the financing has on the value. The value of a property on the basis of cash or cash equivalency can be developed most directly by comparing it with similar properties that were being sold for cash or its equivalent on the open market. However, if the total consideration for a comparable sale includes something other than cash, e.g., the exchange of property, life tenancy, or other interest, such consideration should be converted to cash equivalency. Analyzing cash equivalency goes beyond the discounting of debt encumbrances.
If sufficient data to permit a direct market comparison is not available, the cash equivalency of existing or proposed financing can be estimated by discounting the contractual terms at current market rates or yield rates for the same type of property and loan term over the expected holding period of the property. However, such mathematical methods should be weighted against other market indications.

**Comparable Analysis When Financing May Have Affected Value**

The same analysis outlined above must also be applied to comparable sales data. The appraiser should ascertain the terms of the financing involved in the acquisition of a comparable property and estimate the influence of such financing, if any, on the sale price. For example, does an all-cash sale differ from a sale in which the buyer assumed existing financing or secured new financing from the seller, a third party, or both? If so, why and what is the impact on price?

A clear distinction must be made between sale prices that are not affected by financing or other considerations, including sale prices for terms considered by the seller to be equivalent to cash transactions, and sales involving premiums or discounts due to financing. If the financing is unfavorable to the purchaser, one way that the difference may be measured is by the cost to retire the debt. Furthermore, the effect of financing on each comparable sale must be considered in light of the market as of the date of the sale, not the date of valuation of the subject. The appraiser should attempt to determine whether or not, at the time of sale, the financing affected the sale price in the minds of the parties to the transaction. If it did, the effect must be analyzed and an adjustment must be made and reported.

**Summary**

In summary, demonstrated knowledge of the market financing available to the subject and comparable sale properties, analytical judgment, and common sense are required of the appraiser in determining whether or not specified financing impacts the value reported.

USPAP Standards Rule 1-2(c) requires that an opinion of the impact of favorable or unfavorable financing on market value be developed and USPAP Standards Rules 2-2(a)(v) and 2-2(b)(v) require that it be reported. The value reported must be clear and meaningful to the client and cannot be misleading to the intended users.

When non-market financing or financing with unusual conditions or incentives is involved and results in an effect on the value opinion, the appraiser can either:

- Report two values (as financed and cash-equivalent); or
- Report one value and indicate the positive or negative influence the financing terms have on the value reported.

**Summary of Standard Practices**

1. Accurately report the specific terms of any non-cash-equivalent existing or proposed financing of the subject property, when such financing has an impact on the appraisal problem (USPAP SR 1-2(c)).
2. Analyze and report the effect of favorable or unfavorable financing terms on value (USPAP SR 1-2(c)).
3. Analyze and make appropriate adjustments to a comparable sale that included favorable or unfavorable financing terms as of the date of sale, when comparing the sale to the property being appraised (USPAP SR 1-2(c)).
4. Either report two values, or report one value and quantify the positive or negative influence the financing terms have on the value reported (USPAP SR 1-2(c)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members, Candidates, Practicing Affiliates and Affiliates with guidance as to how the requirements of the Standards may apply in specific situations.)

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