Valuation of Accessory Dwelling Units

by Sandra K. Adomatis, SRA

Abstract
Accessory dwelling units are on the rise amid ongoing shortages of housing inventory, particularly in the affordable housing sector. In a growing number of states and urban metropolitan centers, excessive market demand for housing is driving up prices of homes and pushing out more affordable housing options. Markets such as San Francisco, California; Portland, Oregon; Seattle, Washington; and others have adopted zoning changes to provide relief to the housing challenges. Increasingly, municipalities are updating their zoning to legally and relatively easily allow single-unit housing to add one or more accessory dwelling units (ADUs). This article will focus on the ADU trend within the context of changing zoning, lending, and appraisal guidelines, and its valuation niche for the appraiser.

Introduction
Accessory dwelling units (ADUs) are not new and can be traced back to the early twentieth century, when they were a common feature in single-family housing (i.e., today known as one-unit housing) throughout cities in the United States, prior to the implementation of zoning ordinances.1 Currently, ADUs are a growing trend in large metropolitan cities. Recent changes in the secondary mortgage market appraisal guidelines give more guidance and flexibility in valuing and financing these units. Prior to the 2020 Fannie Mae Selling Guide update, it was next to impossible for appraisers to meet federal Agency appraisal guidelines, because three sales of comparable ADU properties were extremely difficult to find in the local market. Consequently, ADU property owners found it necessary to seek financing from private lenders, small banks, or credit unions that did not sell to the secondary mortgage market.

ADU Definitions
The best place to start any discussion of ADUs is to look at how this housing choice is defined. As the following discussion shows, the definitions of ADUs vary. This highlights the importance of knowing not only lending and appraisal guidelines for secondary mortgage markets but also the local zoning definitions.

The Dictionary of Real Estate Appraisal defines an ADU as “a small, self-contained dwelling, typically with its own entrance, cooking, and bathing facilities, that shares the site of a larger, single-unit dwelling. ADUs may be attached or built in, such as a basement apartment, or detached, such as a backyard cottage. The owner of the accessory dwelling unit is the same as the owner of the primary dwelling.”3 The federal government agencies define ADU as noted below.4

2. “Agency” as used throughout this article refers to Fannie Mae, Freddie Mac, US Department of Veterans Affairs (VA), US Department of Housing and Urban Development/Federal Housing Administration (HUD/FHA), and US Department of Agriculture (USDA).
4. The USDA does not define ADU.
Valuation of Accessory Dwelling Units

A primary one-unit dwelling. The ADU must provide for living, sleeping, cooking, and bathroom facilities and be on the same parcel as the primary one-unit dwelling.5

- **VA**—An ADU is “a living unit including kitchen, sleeping, and bathroom facilities added to or created within a single-family dwelling, or detached on the same site. A manufactured home on the site could be an ADU. The dwelling and the ADU together constitute a single real estate entity.”6
- **Freddie Mac**—An ADU is “an additional living area that includes at least a kitchen, a bathroom, and a separate entrance and is independent of the primary dwelling unit.”7
- **HUD/FHA**—An ADU is “a habitable living unit added to, created within, or detached from the primary one-unit, single-family residence, which together constitute a single interest in real estate. It is a separate additional living unit, including kitchen, sleeping, and bathroom facilities.”8

While the ADU definitions may be worded differently, their common component attributes include the following:
- Kitchen  
- Bath  
- Sleeping area  
- Separate entrance  
- Shared site with single-family structure

Keep in mind that ADU definitions in local zoning ordinances may vary from the Agency descriptions. It is the appraiser’s responsibility to address not only Agency appraisal guidelines or requirements, but also the zoning as it applies to the space. When they conflict, the appraiser must analyze the market and how it reacts to this space, and clearly describe the findings in the appraisal report to avoid being misleading. Having a good understanding of the Agency appraisal guidelines and lenders requirements that may exceed the Agency guidelines is a must.

This article focuses on the three areas that are important specifically to users of valuation services in the area of ADUs as well as in the valuation of all properties:
- Zoning classification and description  
- Zoning and highest and best use analysis  
- Appraisal report documentation versus workfile support

**Zoning Classification and the Master Plan**

In the past, financing was not the only barrier to utilization of ADU residential housing. Local land use, zoning ordinances, and planning controlled by local governments also presented barriers for ADUs. These barriers resulted in ADUs being added illegally. When not properly permitted, the public property record does not identify the ADUs and often multiple listing services (MLSs) do not code them, which complicates the search for comparable sales. As a result of these factors, past ADUs built without proper building permits were given no value in the market value appraisal.

However, changes in state and local zoning regulations are taking place around the country to address affordable housing and housing shortages in densely populated areas. These changes in law are having tremendous impacts on the highest and best use of properties in these neighborhoods. Appraisers must be aware of and understand the implications that zoning changes have in the valuation process; this ensures competent completion of an appraisal assignment in these markets. For instance, on January 1, 2020, new zoning laws went into effect in Minneapolis. Subsequently, the Minnesota Department of Commerce (the regulatory body for appraiser licensing and enforcement in Minnesota) reviewed 135 appraisal reports of Minneapolis properties. It found that only 117 of these

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appraisals had the correct specific zoning classification, only 15 included the correct zoning description, only 3 had a highest and best use analysis that conformed to USPAP, and none of the appraisals had data in the workfile to support the highest and best use analysis or conclusion. This is a cautionary tale about staying abreast of the education and training to avoid such non-compliance issues and to complete these assignments competently.  

**ADU Recognition and Rationale.** A combination of the housing shortage and the rising cost of single-unit houses has created affordability challenges. As a result of these challenges there has been increased interest in accessory dwelling units. One benefit of adding an ADU or purchasing a home with one is rental income that may improve the affordability of the homes by adding an income stream. Although many zoning ordinances allow for an ADU to be rented, recognize that rental income from an ADU cannot be considered in qualifying a buyer for a Fannie Mae or Freddie Mac loan. However, institutions offering alternative loan products or not selling to the secondary mortgage market may consider the rental income in qualifying the buyer.

Another pro for adding ADUs in one-unit housing neighborhoods is the ability to construct them in less time and with fewer restrictions than building the primary dwelling structure on the subject’s site. Properties with sufficient lot sizes to accommodate these smaller units can be ideal for an ADU if they meet setback and other zoning requirements.

Proponents of ADUs suggest the addition of ADUs will not change the character of a residential neighborhood. Historical homes often had a carriage house over a garage, or a servant’s quarter, without negative consequences to values. Each market will have its own experience with ADUs as the following examples show.

- **Washington, DC,** has a number of old alley apartments, many of which date back to the 1700s. These alley apartments met a housing need at the time and still do. While many have been removed (most likely due to condition and quality of construction), approximately 20 alleys with alley apartments still exist.  

- **Chicago** at one time prohibited ADUs, but due to the housing shortage and affordability concerns, the city council passed an ADU ordinance on December 16, 2020, that allows ADUs in five districts (North, Northwest, West, South, Southeast); within those districts, the ordinance includes all R zones, except RS-1. These areas are part of a pilot project.

- **California** passed legislation in 2017 that superseded local zoning ordinances regarding ADU permissibility. The intent behind this sweeping legislation was to provide a form of relief to the housing affordability challenges in the state. Under this law, local jurisdictions could no longer prohibit ADUs within residentially zoned districts. In 2019, California made additional changes to the law that made it easier for previously non-permitted ADUs to obtain a permit. In 2020, the law made some additional significant modifications. Consequently, California appraisers must know and understand the laws regarding ADUs at both the state and local level and appropriately apply such requirements to the valuation of properties with ADUs.

In addition to affordability, ADUs are thought to have a lower impact on the environment than a single-unit or multifamily structure. They lessen urban sprawl, which requires more resources and

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9. Minnesota Dept. of Commerce Report, June 1, 2020. The real underlying problem was the lack of summarizing the analysis in the appraisal report.

10. Fannie Mae Selling Guidelines, Section B2-3-04, Special Property Eligibility Considerations (September 2020).

11. The *Intelligencer* reported in 1865 that many “were made of cut-rate lumber and covered with tar or felt.” See Nina Tristani, “History: Capitol Hill Alley Dwellings,” *Hill Rag* (March 8, 2018), https://bit.ly/3ITfWyP.

services that impact the environment and housing costs. ADUs can be designed to blend in with the surrounding architecture and primary dwelling unit, be compatible with established neighborhoods, and preserve community character. In some markets, however, resistance to ADUs is based on concerns related to parking requirements, overcrowding, loss of residential neighborhood character, and/or negative effect on existing and future property values.

Zoning and Highest and Best Use Analysis
The first step in developing the highest and best use analysis is knowing what is legally permissible. The appraiser needs to investigate what is legally permissible related to ADUs, which brings us to examination of the jurisdiction's master plan and zoning designations. When investigating what is legally permissible, look to the master plan for the subject's jurisdiction to understand how the community is currently dealing with residential properties and ADUs—and its plans for the future. The following items should be researched.

1. Do changes over time increase the ability to add such units to existing or new construction markets?
2. What time frame are changes expected?
3. Have ADUs been discussed at the government level, e.g., board of supervisors, county elected officials, etc.?
4. What has been the tenor of such housing change discussions—favorable, not favorable, neutral?

This type of information is part of the neighborhood description regarding trends, the site section when discussing zoning description of trends, and the approaches to value, specifically the tenor of the elected officials toward the ADU housing option. Lenders need to know if this is a common improvement addition in other homes in the subject's market and the political attitude going forward for this housing product type based on the master plan and other zoning data collected.

A misconception by some residential appraisers is that it is acceptable to simply state or paraphrase the zoning and not include a description of the zoning. It is not sufficient to simply state the zoning as “RSF.” It is not sufficient to paraphrase the zoning as “residential,” “rural,” or “multifamily.” None of those are actual zoning designations in most, if not all, jurisdictions. Instead, they are commonly considered zoning categories. The actual zoning designation and description for the subject—meaning the zoning classification and details of that zoning—must be researched and analyzed to determine if the appraised property is legal, legal conforming, legal nonconforming, illegal, or constructed without building permits in the subject's jurisdiction. In many jurisdictions, zoning information is accessible online, making it easier to research and document the appraisal report and workfile.

Remember, the zoning provisions may not—and likely will not—define an ADU the same way as the secondary mortgage market, although both are important to the lender. In the appraisal report, it is necessary to identify and describe (1) the applicable zoning for the ADU based on the zoning ordinance, (2) the analysis applied to determine the subject's highest and best use conclusion that includes whether the subject meets the zoning ordinance or not, and (3) how the data collected, verified, and analyzed applies to the lender's guidelines or requirements based on the engagement (e.g., are Fannie Mae or Freddie Mac appraisal guidelines or FHA or VA appraisal requirements applicable in the assignment). Completing and reporting these steps will make it clear to the lender how the subject does (or does not) comply with the subject's zoning, how the highest and best use conclusion is supported, and thereafter how to proceed with the underwriting requirements of the loan.

13. The Dictionary of Real Estate Appraisal, sixth edition, defines a master plan as “a comprehensive, long-range official plan that guides the physical growth and development of a community, combined with the basic regulatory and administrative controls needed to attain the physical objectives; includes land use plan, thoroughfare plan, community facilities plan, and public improvements program. Master plans are usually revised periodically... In some jurisdictions, the master plan takes precedence over the existing zoning.”
Mortgage Market Guidelines
The following overview of the lending appraisal guidelines for single-unit properties with ADUs illustrates the importance of understanding the intended use and user of the appraisal. Not all appraisal guidelines are the same, and a lender/client may have a different guideline that is not the same as the Agency guideline. The table in Exhibit 1 compares the appraisal guideline differences among the government-sponsored enterprises (GSEs) and the Agencies and illustrates how complicated an ADU appraisal assignment might become. It is extremely important to research the zoning, master plan, and lending guidelines before moving forward with the assignment. The primary differences between zoning and the secondary mortgage market and government agencies most often fall into three categories: (1) rooms required (GSEs and Agencies require kitchen, bath, sleeping/living area); (2) separate entrance (Fannie Mae and Freddie Mac require a separate entrance); and (3) legal status (VA and FHA require legal status).

Keep in mind, the guidelines in Exhibit 1 are for lending purposes and would not apply to a client outside the lending world. The intended use and intended user are important to understand the appraisal guidelines or requirements that apply.

Data Sources and Challenges
Properties with features that are new to the market or that are not easily identified in common data sources create challenges for appraisers in developing supportable opinions of value and clarity as to the market’s reaction to the feature.

MLS and Public Records Data. All MLSs do not have searchable fields to identify ADU properties. Public records also may not separate the ADU living area from the main structure. Using a variety of key search terms is typically the best way to find ADU properties that have sold or been actively listed for sale. It is also necessary to search listings that are expired, pending, and temporarily off the market as well as dated sales to complete the market analysis and uncover market reaction to ADU properties.

The Agency appraisal guidelines require the appraiser to address the market’s reaction to a feature. The key to identifying the market reaction or penetration is through extensive searches of multiple sources each with its limitations, which is a challenge for even the most experienced appraiser. In addition to the limitations mentioned previously, the following other factors compound the difficulty of the data search:

- A wide variety of names are used for ADUs.
- Data sources seldom have standard data for ADU improvements.
- Data sources, like public property records, often do not identify the ADU improvement or identify it inaccurately as a shed or outbuilding.

These challenges complicate the appraisal assignment and the ability to meet the appraisal guidelines or requirements as well as USPAP standards. Therefore, understanding how the specific market identifies ADUs is the first step to successfully completing the market analysis. The following is a partial list of names found for ADUs, and it reveals the added challenge in identifying the units through the internet websites or MLSs. Word searches of these data sources are the best step to finding homes with ADUs that are listed, sold, expired, or rented. Remember, market reaction is more than a search for comparable sales; it is a search to identify the existence of ADUs in this market. Research should include the following terms to identify ADUs in a market and to understand the market’s acceptance of this feature:

- accessory apartment
- accessory dwelling
- accessory dwelling unit
- accessory suite (an attached ADU)
- accessory unit
- ADU
- ancillary unit
- backyard cottage
- basement apartment
- carriage house
- casita (Arizona)
- coach house
- granny cottage
- granny flat
- in-law suite
- in-law unit
- junior accessory dwelling unit/JADU (a small, internal ADU)
- mother-in-law flat
- multigenerational homes
- “Next Gen” (a commercial name by Lennar)
- ohana unit (Hawaii)
- two-family house
**Exhibit 1** Mortgage Market ADU Guidelines

<table>
<thead>
<tr>
<th></th>
<th>Fannie Mae</th>
<th>Freddie Mac</th>
<th>VA</th>
<th>HUD/FHA</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADU defined in the guidelines</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Must ADU be legal to be eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>ADU cannot be included in gross living area of primary structure</td>
<td>Correct</td>
<td>Correct</td>
<td>Correct</td>
<td>Correct</td>
</tr>
<tr>
<td>Must ADU be owner occupied?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Is ADU required to have a kitchen, bathroom, bedroom, and living area?</td>
<td>Bedroom not required (can be an efficiency)</td>
<td>Bedroom not required (can be an efficiency)</td>
<td>Bedroom not required but sleeping area is</td>
<td>Bedroom not required but sleeping area is</td>
</tr>
<tr>
<td>Must ADU have a building permit to be eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Is separate meter and address required for ADU?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Does attached or converted space ADU require separate access from the primary dwelling?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>If required by zoning</td>
</tr>
<tr>
<td>Is ADU used as a short-term rental eligible for financing?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, as long as it remains residential</td>
<td>May if HBU classifies it residential</td>
</tr>
<tr>
<td>Is a two- to four-unit with an ADU eligible for financing?</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Legal Use—No. of comparables with ADUs required in sales comparison grid</td>
<td>1 w/ADU*</td>
<td>1 w/ADU min</td>
<td>3 closed comparables (best available)</td>
<td>1 w/ADU minimum</td>
</tr>
<tr>
<td>Illegal Use—No. of comparables with ADUs required in sales comparison grid</td>
<td>2 w/illegal ADUs</td>
<td>2 w/illegal ADUs</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Dated sales accepted as comparables?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Are listings and pending sales accepted to show marketability and market reaction?</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
<td>As additional exhibits</td>
</tr>
</tbody>
</table>

* All Agencies require 3 or more comparables in the sales grid with support for adjustments. While the Fannie Mae appraisal guidelines do not require “comparables with an ADU,” best practice suggests at least one should be in the sales grid when the ADU is legal. This is consistent with Freddie Mac’s requirement and a requirement that lenders might also expect.
Residential appraisers providing mortgage lending appraisals are required to have access to the necessary and appropriate public and private data sources to develop credible assignment results. Appraiser Certification 12 of Fannie Mae Form 1004 requires the appraiser to certify as follows:

12. I am aware of, and have access to, the necessary and appropriate public and private data sources, such as multiple listing services, tax assessment records, public land records and other such data sources for the area in which the property is located.

The MLS is a data service specifically for use in buying and selling properties. As a result, it is a valuable data source for appraisers, where it is available. As useful as an MLS is to an appraiser's daily work, most appraisers have experienced searchable fields that are not populated or inaccurately populated. However, despite any local MLS data integrity issues, the MLS can provide leads to properties that are listed, sold, pending, expired, and withdrawn to further investigate, and the MLS usually gives more detailed information than the public assessor property records.

Because not all MLSs will have data entry or searchability for special improvements such as ADUs, some ingenuity is needed in the keyword searches to find ADU comparables sales, listings, pending sales, or other useful transaction data. A search for sales for a more extended period (such as the past five years) can be helpful in identifying how many properties in the market may have ADUs. Even if listed properties were not sold, at least the appraiser can confirm there are other properties with ADUs in the market and identify them by address to illustrate market reaction. Again, it is important to research a variety of terms to gather the most complete information. The following are suggestions for a possible “word search” in the local MLS to identify ADU transactions.

<table>
<thead>
<tr>
<th>Word Search Options</th>
<th>Common Word Search Results</th>
</tr>
</thead>
<tbody>
<tr>
<td>Basement</td>
<td>Living quarters</td>
</tr>
<tr>
<td></td>
<td>Apartment</td>
</tr>
<tr>
<td></td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td>Interior Features</td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td></td>
<td>(common if the ADU is part of the primary dwelling)</td>
</tr>
<tr>
<td>Exterior Features</td>
<td>Accessory dwelling unit</td>
</tr>
<tr>
<td></td>
<td>(common if the ADU is a separate structure from the primary dwelling)</td>
</tr>
</tbody>
</table>

The fields and details vary considerably from MLS to MLS, but if a search using one of the previously mentioned terms (or others) results in finding properties with ADUs, property details may also be available in the MLS data. Otherwise, additional investigation will be required in order to properly analyze the subject's ADU improvement against the MLS's ADU improvement search results. For example, it may be necessary to contact the real estate agent or agent's selling office, the seller, or the buyer. Further, the appraiser may need to expand the search to beyond one-unit (e.g., single-family) properties—however, this will depend on how the MLS might qualify or code a property with an ADU. Consider applying the word search options to the multifamily, rental, and even commercial property categories.

Public property records can be more challenging to search than the MLS, depending on the quality of your local assessment data. Following are a few examples of the ways properties can appear in the assessor records. Reviewing these examples gives a better understanding of ways to identify ADUs in public property records.

Illustration 1 Property

**MLS Data:** The MLS search identified a listing of a property in Charlotte County with a “guest house.” No other information provided.

**Public Records Property Data:** The public records search found the MLS listing’s property type as single unit; and current use: multi-single-units (2) single-family residences; single-family residence and mobile home; or (2) mobile homes.

Illustration 2 Property

**MLS Data:** The MLS search for comparable data identified a sale of a property in Sarasota County with a “multi-generational home,” i.e., an ADU with 1 bedroom, 1 bath, separate entrance, and a kitchenette.

**Public Records Property Data:** The public records search found property from the MLS by address in the public property record data with the following information:
- Property Type: Single-family
- Additional Features: None
- Building Area: 1,784 sq. ft.
- Other Building(s): 700 sq. ft.

The public property record incorporated the ADU living area in the main house square footage. Therefore, appraisers should beware of how the living area is identified to avoid major errors. Always verify the data with other sources. The listing of the comparable that sold used the assessor’s square footage of 1,784 sq. ft.; however, the ADU square footage was 700 sq. ft. and included in the main house. This creates a potential for a material error if the appraiser does not verify this information with other sources. Keep in mind the secondary mortgage market has a large database of sales supplied by appraisers and this same sale may be correctly identified in the database. If this is the case, the error might be caught by the secondary market review.

Illustration 3 Property

**MLS Data:** The MLS search identified a historical bungalow with an upstairs “in-law suite” that has a full kitchen, bath, bedroom, and private entrance from the back.

**Public Records Property Data:** The public records search found property from the MLS by address in the public record data, and it identified the following:
- Property Type: Single-family (No mention of an additional kitchen or living space.)
- Building Area: Second Floor Finished Attic
- Additions: “In-law Unit”
- Permits: 650 Sq. ft. Finished Attic 
  Permit Date: xx/xx/xxxx

These examples illustrate just how difficult it can be to identify properties with ADUs and why competency in valuing properties with ADUs is necessary. Geographical experience and knowledge in a market are important, because an appraiser must use multiple data sources to verify information about ADU comparable(s). The illustrations clearly show that one data source is not adequate to obtain property information, since not all data sources provide accurate or complete information about improvements. A best practice is to research multiple data sources and verify data with primary sources. Properly verified data with good market analysis will ensure the work completed results in credible opinions and conclusions and does not mislead the client/intended user.

In addition to public records and the MLS, online technology provides sources for identifying properties with various features such as ADUs. Consider researching the following real estate platforms available in most, if not all markets; they can be valuable search tools for properties with ADUs.

**Zillow.** Zillow is a free, well-known internet-based real estate search platform that is often used by buyers and sellers in the market to obtain a “Zestimate” ([www.zillow.com/z/zestimate/](http://www.zillow.com/z/zestimate/)) of a property’s “value.” While Zillow’s algorithms have come under question through the media, the platform does provide another potential source for identifying ADU properties. Zillow collects both MLS listing and sales data as well as public record data as an aggregate, meaning it collects any public information about the subject property and places it in one location.

The Zillow search example in Exhibit 2 is telling. It provides a wider understanding of trends and data that could be overlooked if the search parameters are too narrow, if only a single source

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Exhibit 2  Zillow ADU Search Example

<table>
<thead>
<tr>
<th>Search Step Tiers</th>
<th>Tab</th>
<th>Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening Search</td>
<td>“Address”</td>
<td>California</td>
</tr>
<tr>
<td>First-Tier Search Options</td>
<td>“Buy” (top left tab above map)</td>
<td>“Recent Home Sales”</td>
</tr>
<tr>
<td>Second-Tier Search Options</td>
<td>“Home Type”</td>
<td>All but “Apartments,” “lots/land”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Sold in Last—“36 Months”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Keywords—“Guest House”</td>
</tr>
<tr>
<td></td>
<td>“More”</td>
<td>Click “Done”</td>
</tr>
</tbody>
</table>

Search Results

75,738 Properties


is used for real estate transactions, if the improvement data information is not verified with multiple sources, or if the Zillow data source is not used. Note, the results of the Zillow search may change as the search parameters are modified. For example, in Exhibit 2

- If in Keywords the term “Guest House” is changed to “Accessory Dwelling Unit,” only 1,625 properties in California meet this criterion and are shown in the search results.16
- If in Keywords the term “Accessory Dwelling Unit” is changed to “ADU,” 11,602 properties in California meet this criterion and are shown in the search results.17
- If in Keywords the term “junior accessory dwelling unit” (JADU) is used, the results show 36 properties in California meet this criterion.18

Realtor.com. Realtor.com is another free and well-known internet-based real estate search platform. It often is used by buyers and sellers in the market to find homes to buy, lease, and sell. Unlike Zillow, it does not provide a “Zestimate” of value of a specific property. However, like Zillow, this website aggregates data based on multiple data sources into one location. The data aggregation includes information from the MLS, public property records, local data consortiums regarding schools for example, and more. As with the previous Zillow search example, the following Realtor.com search was telling. It provided a wider understanding of trends and data that could be overlooked if an appraiser is too narrow in their search parameters, uses a single source for real estate transactions,19 does not verify the improvement data information with multiple sources, or does not use this data source.

Exhibit 3 shows ADU parameters chosen and placed in the Realtor.com search to illustrate search tiers in this platform. Although the Realtor.com data are listings and not sales, this information will support that ADUs exist in the subject market and can further help to support information on ADUs by investigating the listings with their real estate agent and public record data to assist also in finding sales of ADU properties. Like Zillow, if a property has sold and there was an MLS listing, Realtor.com will post that MLS data in its database.

16. However, changing the parameters to a specific city—for example, keeping the city location parameter “Concord, CA”—dropped down the search results to 5,172 properties. If the search is further fine-tuned to a specific area—“Cowell, Concord, CA”—the results further drop to 57 properties.
17. Keeping the location parameters as “Cowell, Concord, CA,” but changing the Keyword search to “ADU” results in the response “no matches.”
18. Keeping the location parameters as “Cowell, Concord, CA,” but changing the Keyword search to “JADU” results in the response “no matches.”
19. Realtor.com will allow additional parameters to be added in the “Buy” option; in other words, properties listed for sale. The option to write in a search parameter is not available under the “Sold Homes” option.
Exhibit 3  Realtor.com ADU Search Example

| Steps in Realtor.com Search |  
|-----------------------------|---|
| **Search Step Tiers** | **Tab** | **Selection** |
| Opening Page | “Buy” + location | Phoenix, AZ |
| First-Tier Search Options | Property type | All but “Any,” “Farm,” Mobile,” “Land” |
| | Listing status | Existing Homes (other options, “New Construction,” “55+Community,” “Foreclosure” |
| Search Results | | 3,717 homes for sale |
| Second-Tier Search Options | “More Filters” | Keywords—“Guest House” (68 listed homes result) |
| | “Alternate More Filters ” | Keywords—“ADU,” “In-Law,” “Granny Unit,” “Casita” (0 homes) |
| | “More Filters” | Location—“Expand Search” + “Search Radius in Miles,” or “Include Nearby Areas” |


Scope of Work
Both the Realtor.com and Zillow research exercises make it clear that the many names in the market for ADUs will affect the results of the data research. It is the appraiser’s responsibility to be competent in knowing what those names/options are to ensure the collection, research, and analysis of data is complete and accurate. Using only one data source or only one term for ADUs in the research could result in opinions and conclusions that are not supported. Data should be verified from primary sources as part of the market research. These steps help avoid issues with clients and with the state appraiser enforcement agency. Being complaceant with the data search, not being competent in the subject market or the ADU property type, and not completing a thorough highest and best use analysis can result in a scope of work that leads to assignment results without credibility due to insufficient support.

The data challenges identified should be described in the scope of work. A scope of work can be in one section of the appraisal report or provided throughout the report from section to section. Remember, the scope of work must provide credible assignment results based on the intended use, and the reporting of the scope of work must not mislead the client or intended user. A well-written scope of work discussion can lessen the appraiser’s liability and give the intended user a better understanding of the complexity of the assignment from the beginning.20

A number of sources provide guidance on scope of work. The Uniform Standards of Professional Appraisal Practice (USPAP) includes the Scope of Work Rule with comments. Stephanie Coleman in the text Scope of Work, third edition,21 explains that the GSEs expect the appraiser to identify throughout the appraisal report form, from section to section and where necessary, the following:

- the extent to which the subject property requires identification, including the neighborhood, market conditions, the site and improvements;

20. The GSEs are currently updating the appraisal report forms, and the language in the new design may change from the current forms. Updates of the uniform appraisal dataset (UAD) may also including coding for ADUs. For a discussion of the redesign initiative, see Fannie Mae, “Uniform Appraisal Dataset,” https://bit.ly/3FcOlXk.
22. The GSE appraisal guidelines and scope of work do not limit the appraiser to only these statements.
• the extent to which the property is inspected, including the site and all the improvements, as well as what was not inspected;
• the type and extent of data researched by the appraiser, because data used to determine the market conditions is not the same data to determine what sales are comparable to the subject in the approaches to value; and
• the type and extent of analyses applied to arrive at opinions or conclusions throughout the appraisal report form and addenda, such as the analysis of land sales in the subject neighborhood and another neighborhood to determine comparability, using the age-life method in the cost approach to determine depreciation, the paired sales method in the sales comparison approach to determine adjustments, etc.25

The Scope of Work provision in the Fannie Mae 1004/Freddie Mac 70 Appraisal Report (March 2005, page 4), states as follows:

**Scope of Work**

The scope of work for this appraisal is defined by the complexity of this appraisal assignment and the reporting requirements of this appraisal report form, including the following definition of market value, statement of assumptions and limiting conditions, and certifications. The appraiser must, at a minimum: (1) perform a complete visual inspection of the interior and exterior areas of the subject property, (2) inspect the neighborhood, (3) inspect each of the comparable sales from at least the street, (4) research, verify, and analyze data from reliable public and/or private sources, and (5) report his or her analysis, opinions, and conclusions in this appraisal report.

The Appraisal Institute text *The Scope of Work*, third edition,24 is a good resource for developing the scope of work wording for a variety of assignments. The Appraisal Institute seminar *Valuation Overview of Accessory Dwelling Units* is also helpful; it reviews several scope of work examples that would apply to ADU property appraisals. In residential lending work, appraisers often rely on the preprinted scope of work language; however this may not be adequate in an ADU assignment. A well-developed scope of work is important to lessen liability and provide an understanding of the extent to which the appraiser analyzed the market data. When developing the scope of work, keep in focus the intended use, intended user, and type of value, which are important to the credibility of the appraisal. As Coleman cautions in *Scope of Work*, third edition,25

*Don’t forget:* The scope of work is a critical step in the appraisal process. The manner in which you address scope in your report should underscore its importance. In the briefest of appraisal reports, the scope of work discussion might well comprise the bulk of the report.25

**ADU Valuation Dilemmas**

**Sales Comparison Approach**

The sales comparison approach is the most-often used approach to value driven by the fact that certification in the appraisal report forms specifically requires it.26 The secondary mortgage market and government entity appraisal guidelines address the sales comparison selection as follows:

- Dated settled sales may be used to demonstrate market acceptability, and
- Active listings or pending sales may be used as supplemental exhibits to show marketability.
- Include a traditional comparable with an ADU in the sales comparison grid. At least one ADU comparable is required.

Depending on how scarce current sales, listings, or pending sales are to support a market for a subject with an ADU, the appraiser may con-

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26. Fannie Mae Form 1004, Appraiser Certification 4, states “I developed my opinion of the market value of the real property that is the subject of this report based on the sales comparison approach to value. I have adequate comparable market data to develop a reliable sales comparison approach for this appraisal assignment. I further certify that I considered the cost and income approaches to value but did not develop them, unless otherwise indicated in this report.”
Consider the use of expired listings and withdrawn listings or may go further back in time but stay within the defined subject neighborhood or market area. An important detail to consider is that the dated settled sales, listings, or pending sales do not have to be comparable properties to the subject in order to support the presence of a market for ADU properties in the subject neighborhood/market area.

Suppose, for instance, the property being appraised is 2,100 square feet with a 750-square-foot ADU. The dated settled sales, listings, and/or pending sales are 1,200 square feet to 2,500 square feet, with ADUs that vary from 500 square feet to 800 square feet. These properties would not be placed in the sales comparison grid because they do not represent “comparable” sales to the subject. Instead, such data would be identified in the text addendum and summarized in sufficient detail to support the appraiser’s highest and best use opinion regarding the market’s reaction to single-unit properties with ADUs. This data further answers the underwriter’s question, Is the ADU a feature that is accepted in the subject’s defined neighborhood/market area?

In 2020, Fannie Mae issued its ADU update. Some clients/lenders, reviewers, and underwriters may be unfamiliar with the latest document. Therefore, it would be most helpful, and likely a time saver to the appraiser and those involved, if this documentation is cited or referenced in the appraisal report.

Paired-Data Analysis, ADU Value Contribution.
The following paired-data analysis example involves a hypothetical ADU. It provides a good illustration of a pairing to extract the value of a feature from the market. The two sales in Exhibit 4 are similar in all respects except Sale 2 does not have an ADU. A market conditions adjustment is not warranted based on a history of sales in the last two months. The minor difference in the gross living area (GLA) of the primary structure is not recognized by the market. A real estate agent interviewed for both sales indicated the condition and quality of construction is similar. While properties are not in the same subdivision, they are in adjacent subdivisions that compete for the same buyers. This pair is a strong indicator of the contributory value of the ADU at $75,000 or $130.44 per square foot of the ADU living area. Sale 1’s owner reported the attached ADU was constructed four years ago for $125,000.

Remember, one paired-data set does not make a market. Appraisers must use evidence and logic in reconciling the pair(s) to see if they make sense for use in supporting conclusions in the appraisal report. For instance, if the paired analysis suggested the ADU had a contributory value of $150,000 after construction costs of $125,000 four years ago, that conclusion might not make sense. The market is not perfect, and sometimes results are not logical. Always use a test of reasonableness before placing weight on a single method or result, then reconcile the conclusion to allow the reader to follow the analysis logic.

Exhibit 4 Paired-Data Analysis, ADU Value Contribution

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Sale 1</th>
<th>Sale 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sale Date</td>
<td>6 months ago</td>
<td>8 months ago</td>
</tr>
<tr>
<td>Sale Price</td>
<td>$890,000</td>
<td>$815,000</td>
</tr>
<tr>
<td>$/SF</td>
<td>$404.55</td>
<td>$383.53</td>
</tr>
<tr>
<td>Lot Size</td>
<td>18,000 SF</td>
<td>22,000 SF</td>
</tr>
<tr>
<td>Single-Family Dwelling GLA</td>
<td>2,200 SF</td>
<td>2,125 SF</td>
</tr>
<tr>
<td>Room Count</td>
<td>6/3/2.5</td>
<td>6/3/2.5</td>
</tr>
<tr>
<td>Basement</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>ADU Size/Age</td>
<td>575 SF/4 yrs.</td>
<td>None</td>
</tr>
<tr>
<td>Adjusted Sale Price</td>
<td>$890,000</td>
<td>$815,000</td>
</tr>
<tr>
<td>Difference</td>
<td>$75,000 ($890,000 – $815,000)</td>
<td></td>
</tr>
</tbody>
</table>

27. Fannie Mae, Selling Guide, B4-1.3-05, Improvements Section of the Appraisal Report.


**Exhibit 5** Sensitivity Analysis to Isolate Value of ADU

<table>
<thead>
<tr>
<th>Features</th>
<th>Base Comparable 1</th>
<th>Comparable 2</th>
<th>Comparable 3</th>
<th>Comparable 4</th>
<th>Comparable 5</th>
<th>Comparable 6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td>$785,000</td>
<td>$855,000</td>
<td>$775,000</td>
<td>$900,000</td>
<td>$750,000</td>
<td>$765,000</td>
</tr>
<tr>
<td>Contract Date</td>
<td>Current</td>
<td>3 months ago</td>
<td>2 months ago</td>
<td>1 month ago</td>
<td>4 months ago</td>
<td>2 months ago</td>
</tr>
<tr>
<td>Condition</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
<td>Good</td>
</tr>
<tr>
<td>Site Size/Sq.Ft.</td>
<td>8,000</td>
<td>9,500</td>
<td>8,700</td>
<td>10,500</td>
<td>7,500</td>
<td>8,000</td>
</tr>
<tr>
<td>Gross Living Area</td>
<td>1,750</td>
<td>1,625</td>
<td>1,695</td>
<td>2,100</td>
<td>–26,250</td>
<td>1,525</td>
</tr>
<tr>
<td>Parking</td>
<td>2-car garage</td>
<td>2-car garage</td>
<td>2-car garage</td>
<td>3-car garage</td>
<td>–10,000</td>
<td>2-car garage</td>
</tr>
<tr>
<td>ADU</td>
<td>No</td>
<td>Yes-600 SF</td>
<td>–75,000</td>
<td>Yes-575 SF</td>
<td>–75,000</td>
<td>No</td>
</tr>
<tr>
<td>Basement</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>Other</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>

| Adjusted Sale Price       | $780,000          | $775,000     | $788,750     | $766,875     | $765,000     |

| Variance as a percentage  | –0.64            | –1.27        | 0.48         | –2.31        | –2.54        |

| Average Percentage Variance versus Base Sale | –1.26 |

**Sensitivity Analysis.** A test of reasonableness might include a sensitivity analysis. Apply the adjustment from the paired-data analysis to a series of “comparables,” and see if the adjusted sale prices reflect a reasonable range based on the data collected and verified for sales in the subject market and the market trend analysis conducted.

Sensitivity analysis is the process of isolating how change in one or more variables may affect an outcome variable like property value. Sensitivity analysis is often used to support investment risk analysis. In Exhibit 5, Comparable 1 is the base comparable and adjustments are applied to the primary five comparable sales. Adjustments for other differences are developed using paired-data analysis and market surveys of real estate agents. The market has not shown significant differences over the four months difference in market time; therefore, no adjustment for date of sale is required. The data supports a finding that minor differences in GLA are not recognized by buyers; therefore, no adjustment is applied for differences of less than 100 square feet in GLA. The ADU adjustment identified in the previous paired-data analysis (Exhibit 4) is applied to Comparables 2 and 4. After applying the $75,000 adjustment for the ADU to those two sales, the range tightens for the base sale. The overall average variance of –1.26% is insignificant, which lends good secondary support to the ADU adjustment of $75,000.

**Income Capitalization Approach**
Single-unit properties can be appraised using the income capitalization approach by
- Analyzing market rents to establish the potential market rent for the subject.
- Developing a gross rent multiplier (GRM) by finding similar sales that were rented at the time of the sale and dividing the sale price by the monthly rent to arrive at a GRM.

Obtaining monthly rentals of single-unit homes is less challenging than the second step of obtaining GRMs. In the absence of GRMs developed from market sales of rental properties, GRMs can be extrapolated. The method combines the sale of a property similar to the subject with the rental data collected from another property also similar to the subject. The concept is that if the property that sold had been rented at the time of sale, the rental rate would have been similar to the property rented (but not sold).

Extreme caution is necessary, however, in making the choice to use a market-extracted GRM.

multiplied by a market-extracted rental rate and applying it to the ADU of the subject or a comparable to develop an opinion of value for the ADU. The reasons for caution include the following:

- A GRM includes rent attributed to the land and the improvements.
- Applying a single-unit or multifamily GRM to the rent of an ADU would overvalue the ADU, because it would include the value for the land that already was accounted for with the primary dwelling.
- The ADU does not have land as part of the value contribution; it is the value attributed to a secondary unit on a primary dwelling site that is being established.
- It is possible to extract the land value from the GRMs; however, that complicates the appraisal assignment, requires extensive support and explanation for the client/lender to understand, and is not a typical method buyers seeking one-unit dwellings with ADUs will use to determine the ADUs’ worth to them.
- Finding similar single-unit sales with ADUs where both primary dwelling and ADU are rented would be ideal, but rarely do those exist in sufficient supply to provide a credible value opinion.

The rent potential or existing rent/lease of the ADU should be analyzed. A discussion of why the income capitalization approach is not applicable is also an important step in the final reconciliation.

**Income Capitalization Approach Example—GRM Applied to the Accessory Dwelling Unit Rental.**

The following example illustrates how an income capitalization approach would apply when the primary dwelling and ADU are both rented, and the market analysis indicates houses with ADUs in this market are rented. Just because the subject is rented does not indicate an income capitalization approach is applicable if it is the only house in the neighborhood that is rented.

In this example, suppose the primary dwelling unit is rented at $3,500 per month and the ADU at $1,500 per month. Both units have annual leases with the tenants paying utilities. The ADU has separate utility meters for billing. The only expenses paid by the landlord are real estate taxes and insurance as is customary in the market area. A comparable search for properties rented supports the current market rents for both the primary dwelling and the ADU. The details of the rentals must be summarized in the appraisal report to support the rental opinion conclusions.

A comparable search for properties that sold and were rented at the time they sold resulted in three comparables. Two are dated sales and one is a recent sale. The details of the GRM properties are summarized in the appraisal report to address their comparability to the subject property. The two dated sales support GRMs of 120 and 125 while the most recent sale supports a GRM of 130. The sales form a reasonable range of GRMs. In the GRM reconciliation, the more dated sales deserve less consideration, because they have fewer updates than the subject property. The more recent sale deserves the most consideration because it is in the subject’s neighborhood and most similar in condition and updates, supporting a GRM of 130. Using the income capitalization approach and applying the formula \( \text{GRM} \times \text{Monthly Rent} = \text{Value} \), yields the following value indication:

\[
\$3,500 \text{ plus } \$1,500 \text{ monthly rent } (\$5,000) \times 130 = \$650,000
\]

**Payback Period.** Another way market rent can be valued is by establishing a period in which it would be reasonable to recoup the investment of the adjusted value of the ADU. Assume the ADU has a contributory value of $75,000 (developed using three paired-data sets), and the actual market rent for the ADU is $1,500 per month. How long will it take the owner to receive $75,000 back in rent collected assuming there are no annual rent increases or decreases? The payback period formula below suggests a period of 4.17 years.

\[
\frac{\$75,000 \text{ contributory value}}{\$1,500 \text{ monthly rent}} = 50 \text{ months}/12 \text{ months} = 4.17 \text{ years}
\]

However, the example does not account for primary tenancy, real estate taxes, and insurance and does not consider rent increases or decreases. These additional expense and potential rent changes may not extend the payback period significantly unless market changes are dramatic. For example, a natural disaster could instantly change the rental market. Similarly, a major employer entering or exiting the market area could cause significant change. A discussion of the payback period is a reasonable supplemental discussion to support the indicated value by the paired-data analysis method.
In this example, the investor who pays $75,000 for the subject’s ADU is anticipated to receive the payback of their investment (gross rent) in a little over four years. A quick payback period such as that is extremely attractive for real estate investors. Even an owner-occupant would find this to be an attractive real estate investment. While the Agencies do not allow this additional income from the ADU to be considered in qualifying the borrower for a mortgage loan, it can be significant in assisting the primary dwelling’s owner-occupant with monthly mortgage or utility expenses, or obtaining a private loan or seller carry back loan.

**Cost Approach**
The cost approach is another method that can provide secondary support to the sales comparison approach. The replacement cost new should be supported with local data because of the jurisdictional requirements that can materially affect cost. Some factors that can significantly impact the cost new include the following:

- Detached units cost more to construct than attached units
- Building permit cost
- ADU impact fees, if any
- Review and approval process involving a development review committee that may be required for additions to an ADU
- Economies of scale where ADUs cost more per square foot to build than the primary dwelling
- Cost to comply with specific building ordinances that must be met, like parking requirements, setbacks, and height restrictions

Once the cost new is established, the next most difficult step is supporting the depreciation, including potential obsolescence from all forms of loss. In appraisal, *depreciation* is “a loss in property value from any cause; the difference between the cost of an improvement on the effective date of the appraisal and the market value of the improvement on the same date.” This step is challenging but must be based on market data to avoid being subjective. Remember that even proposed or new construction improvements should be analyzed for obsolescence. Developers will and can use outdated floor plans for fast and cheaper construction and greater profit, yet those outdated floor plans may be the reason the sales are slow in that subdivision. Therefore, recognize the terms “proposed” or “new” do not eliminate the concept of functional obsolescence. Proving this step with good market evidence requires sales data of similar units to understand how the cost new relates to the contributory value of the ADU. *Contributory value* is “a type of value that reflects the amount a property or component of a property contributes to the value of another asset or to the property as a whole.”

The definition of depreciation places emphasis on the sales comparison challenge of finding comparable ADU property sales to establish the contributory value of the ADU to compare to the cost new of the ADU. The Fannie Mae guidelines do not allow the cost approach as the primary (or only) basis for an opinion of value. While the cost of repairs, updating, remodeling, etc. are commonly considered by buyers and sellers when negotiating a home sale price, the cost approach does have weaknesses. Experienced appraisers will discuss the strengths and weaknesses of each valuation approach as it applies to the appraisal problem they are solving. When the final reconciliation is well-written, it provides the client/intended user with a clear understanding of the methods used and/or omitted and a summary of the reasons why one method deserves more consideration in the value opinion.

29. A review of various municipal departments governing development and planning indicates that a development review committee generally is charged with reviewing land use plans, preliminary subdivision plans, development plans, and additions. In locations where such reviews are required prior to approval, the process may require longer for approval and add costs to the project that may not be considered in the cost new sources.

30. Usually the smaller the space, the more expensive the cost per square foot. *Economies of scale* refer to the “reduction in cost of production per unit due to a large number of items produced.” Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. “economies of scale.”


Conclusion

ADUs are not new but are gaining in popularity as a way to meet today’s growing housing needs that include multigenerational family units and a supply of affordable housing. ADUs are a part of the sustainability movement. Municipalities are realizing ADUs take advantage of the current infrastructure instead of exacerbating urban sprawl that increases demand for extending services and results in higher taxes and delays in meeting housing demands. As the market’s demands change, so must zoning, financing, marketing, and valuing properties with features such as ADUs. Appraisers prepared to address the ADU appraisal problem will be in demand as these trends continue to grow.

About the Author

Sandra K. Adomatis, SRA, LEED Green Associate, NAR Green, is the 2022 incoming vice president of the Appraisal Institute. Her one-year term as vice president will be followed by one year each as president-elect, president, and immediate past president. Adomatis is the principal of Adomatis Appraisal Service in Punta Gorda, Florida. She specializes in residential valuation, green construction, solar photovoltaic systems, and expert witness testimony for assignments that include eminent domain, construction defects, bankruptcy, and fraud litigation cases. She is a published author in The Appraisal Journal, and author of the book Residential Green Valuation Tools. Adomatis has received Appraisal Institute awards for her work including the Lifetime Achievement Award, and the Armstrong/Kahn Award and Swango Awards for her outstanding Appraisal Journal articles; the Henry C. Entrenken Lifetime Achievement Award from the Florida Gulf Coast Chapter of the Appraisal Institute; Outstanding Service Award in 2016; AI President’s Award in 2013; Dr. William N. Kinnard Junior Award in 2012; and Region X Volunteer of Distinction in 2010. Contact: adomatis@hotmail.com

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

AARP—Accessory Dwelling Units: A Step by Step Guide to Design and Development

AccessoryDwellings.com—News, Research, and Trends

American Planning Association—ADU
https://www.planning.org/search/?keyword=ADU

Appraisal Institute
Lum Library, External Resources, Resource Links [Login required]
Knowledge Base Bibliographies—Residential Properties, Accessory Dwelling Units

Association of Bay Area Governments—Accessory Dwelling Unit Handbook
https://abag.ca.gov/technical-assistance/accessory-dwelling-unit-adu-handbook

Remodeling magazine—ADU
https://www.remodeling.hw.net/search?q=ADU