

## Financing and Sales Concessions: Do We Adjust or Not? Can Paired Data Analysis Work If We Don't?

by Mark R. Rattermann, MAI, SRA

Sellers, whether they are individuals, brokers, or developers, may make sales concessions to induce a sale. When a buyer wants to purchase a house but cannot qualify for a loan because of excess debt or lack of a down payment, the seller may offer a method to provide cash for the debt payoff or down payment.

In many markets, the lack of needed cash is the biggest obstacle to homeownership. One of the most common tools used by brokers and builders alike is the provision of financial assistance to the buyer. This is a type of sale concession.<sup>1</sup> These inducements paid by the sellers or builders cause an additional cost of sale, which is usually compensated for by raising the negotiated sale price. However, the higher price of a comparable sale causes the indicated value of the subject property to be artificially higher unless an adjustment is made, as shown in Example 1.

### Example 1

Suppose the subject is in a market where prices are declining, and sellers and builders are offering a variety of incentives. An appraiser researching comparable sales may find the following market information for sales of properties that have attributes nearly identical to the subject and have closed within the last few months.

- Comparable 1: A residential property sold for \$325,000 with the buyer obtaining a new mortgage of \$300,000. The seller paid the real

estate brokerage fee, title preparation fee, title insurance fee, and 50% of the closing fee.

- Comparable 2: This property sold for \$350,000 with the buyer obtaining a new mortgage for \$332,500. The seller paid the real estate brokerage fee, title preparation fee, title insurance fee, 50% of the closing fee, and \$25,000 in points for the buyer to buy down the interest rate.
- Comparable 3: This residential property recently sold for \$375,000 with a conventional mortgage of \$325,000. The seller paid the real estate brokerage fee, title preparation fee, title insurance fee, and 50% of the closing fee. Additionally, the seller took back a “forgivable” \$50,000 second mortgage from the buyer. The broker reported that the buyer and the seller shredded the second mortgage documents right after closing.
- Comparable 4: This property sold for \$400,000. The buyer provided 10% for a down payment and financed the remaining 90%. The seller paid the real estate brokerage fee, title preparation fee, title insurance fee, and 50% of the closing fee. The listing agent indicated that all the furnishings in the residence, plus an antique car, were included in the sale. The agent estimated that the personal property had a value of about \$75,000.

What do these sales indicate about the value of the subject? If adjustments are made for the extra cost incurred by the seller, the sales all indicate the

1. For examples of types of concessions, see Appraisal Institute, *The Appraisal of Real Estate*, 13th ed. (Chicago: Appraisal Institute, 2008), 330.

same value: \$525,000. If the adjustments are not made, the value indications range from \$325,000 to \$400,000, which is substantial for sales of nearly identical properties.

There are some appraisers who state that if these concessions are typical, then they need not be adjusted for. The problem with this thinking is that there is no limit as to how much an appraiser can assume is a typical concession. Example 2 illustrates the problem that can arise with this approach.

## Example 2

Suppose the subject real estate is located in a platted subdivision and is improved with a new residence. The reported sale price on the purchase agreement is \$375,000, which is the entry level for new homes in this market. The mortgage amount is proposed to be \$356,250.

The purchase agreement discloses that the seller is paying \$64,125 (18 points) for a “homeownership club” allowance. The appraiser calls the builder and asks about the allowance, and the builder says, “The buyers have a lot of credit card debt, so we are using this allowance to pay it off.” She also says that the money has been paid into a nonprofit that was set up by the builder. This nonprofit will give the money to the buyers at closing to pay off their credit card debt.

When the appraiser asks if the sale price is higher because of this, the builder says, “I am not in this business for fun, of course it is.” The builder tells the appraiser about six comparable sales with almost identical financial arrangements and gives the appraiser the names of two other builders who are doing the same kind of financing and would have comparables. The appraiser calls the other builders who confirm that they have several comparables using a “homeownership club” to get around buyers’ high-debt problems. They also admit the prices are inflated to cover it.

Should the appraiser use these sales as comparables? If no adjustments are made, will the comparables indicate what the subject property would sell for?

Some appraisers would argue that it is not necessary to adjust for these concessions because (1) the concessions did not affect the price and the seller was indifferent to having to pay the extra cost of the sale; and (2) the concessions are typical in the market. However, this thinking could be extended without limit to

concessions, as in this example where the financing concession increased the sale price by 18%.

Here are questions to ask yourself when considering whether to adjust for these concessions:

If the appraisal assumes “typical financing concessions” in the value conclusion,

- Do the intended users know the appraised value of the subject is increased by 1% to 20% because the value assumes the seller will have 1% to 20% higher cost of sale in liquidation of the property?
- If the lender has to sell the property will it also have to pay these costs (1% to 20%) to compete in the market?
- Does the consumer–property owner know that the market value opinion in the appraisal report includes an additional 1% to 20% in closing costs above the normal costs incurred in that market, or do they think they can sell the property for the amount of the appraisal and not pay these extra costs?
- How can a paired data analysis work if an adjustment is not made for these concessions?
- If a lender accepts a value opinion where the concessions are not adjusted out of the comparables, should it loan as much money? Or should the lender lower the loan amount if it will have to pay 1% to 20% in additional costs to resell the property if the loan is foreclosed accordingly?

Foreclosures are a growing reality in the current market. So an important consideration for a lender is, what would the lender net if it forecloses on the collateral where the loan is 80% of the value of the property? Assuming the foreclosed property is worth 95% of the appraised value,<sup>2</sup> the foreclosing lender will usually have to pay a brokerage fee, closing fee, title preparation and other incidental costs to induce the resale. The lender will also have to absorb unpaid back interest and foreclosure expenses. In most markets these cost will add up to at least 15% to the sale price, which should net the lender an amount equal to the loan amount. If the market value opinion includes an additional percentage (1% to 20% for these closing costs), then the down-payment requirements would likely be insufficient to allow a sale without a loss.

2. It is acknowledged that the assumption of a 95% resale price may be unrealistic now in many markets, but it was a believable assumption when the 80%/20% loan-to-value ratios were implemented many years ago.

## Adjustments for Concessions

What happens to a valuation analysis when concession amounts are ignored, adjusted to cash, or treated as typical of sales in the market? Tables 1–3 show examples of paired sales analysis using each of these approaches to concessions. Each table shows that three of the four comparable sales had concessions. In Table 1, no adjustments have been made for the sales concessions. In Table 2, concession adjustments have been made to equal cash. In Table 3, adjustments have been made equal to the concessions.

Note that the range in indicated values is from \$325,000 to \$400,000 in Table 1. The properties are nearly the same, but the range in indicated values is quite large. Without an adjustment, the result defies paired data analysis.

Now look at Table 2, where the same data is shown with cash equivalence adjustments; the range is \$0 and the indicated value is \$325,000. By assuming no concessions, the data gives a conclusive answer, and the paired data analysis works in this case.

Table 3 presents another approach that could be used with the analysis. If the appraiser assumes that the \$75,000 in concessions in Sale 4 is typical, then the adjustments shown in Table 3 are needed—and the adjustments have to be positive. If the concessions are assumed to be typical, the adjustments *must* be positive or the paired data analysis will not work. If the subject has an inferior feature (no concessions) and the comparable sale has the feature (the buyer received a \$75,000 benefit), then a positive adjustment to the comparable is needed.

In Table 3, the range in indicated value is \$0, but the value of the subject is \$75,000 higher than the value indication where the sales were adjusted to cash equivalency. The analysis in Table 3 requires positive financing adjustments, but these are not permitted by most investors and lenders.

## Guidance on Treatment of Concessions

The ultimate question is, what is the correct way to do the analysis of comparable sales when dealing with these concessions. If an appraiser assumes concessions are “typical,” should the appraiser be making positive adjustments to comparables that do not include the concessions? If an appraiser as-

sumes “typical financing concessions,” and there is a higher value because of it, should the appraiser state this in the report? To reduce liability exposure from investors, consumers, etc. should an appraiser state he or she is assuming “typical concessions” and then show the dollar impact on value?

The Uniform Standards of Professional Appraisal Practice addresses this situation in Standards Rule 1-2(c), which states,

In developing a real property appraisal, an appraiser must:

- (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<sup>5</sup>

For appraisers that are performing a Federal Housing Administration appraisal, HUD Mortgagee Letter 2005-02, “Seller Concessions and Verification of Sales,” provides guidance. The appraiser and appraisal requirements for sales concessions are specified as follows.

### Appraiser/Appraisal Requirements

1. The appraiser must report the total dollar amount of the loan charges and/or concessions to be paid by any party on behalf of the borrower and describe which party provided the concession in the Subject Section of the appraisal report. Use of an addendum with the heading “Loan Charges/Sales Concessions” may be required due to limited space provided in the appraisal reporting form.
2. The appraiser must also verify all sales transactions for seller concessions and report those findings in the appraisal. If the sale cannot be verified with someone who has first-hand knowledge of the transaction (i.e., buyer, seller or one of their representatives), the appraiser must clearly state how the sale was verified and explain to what extent.
3. In the Sales Comparison Analysis, Sales or Concession Section, the appraiser must report the type and the amount of sales or financing concessions for each comparable sale listed. If no concessions exist, the appraiser must note “none.”

3. Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice*, 2008–2009 ed. (Washington, DC: The Appraisal Foundation, 2008), Lines 490–498.

**Table 1 Paired Data Analysis without Adjustments for Concessions**

| Subject                                  | Comparable 1     | Comparable 2      | Comparable 3      | Comparable 4       |
|--|------------------|-------------------|-------------------|--------------------|
| Sale price                               | \$325,000        | \$184,21          | \$197,37          | \$210,53           |
| Sale price/GLA                           | \$171.05         | \$184,21          | \$197,37          | \$210,53           |
| <b>Value adjustments</b>                 |                  |                   |                   |                    |
| Date of sale/time                        | \$ 0 concessions | \$25,000 concess. | \$50,000 concess. | \$ 75,000 concess. |
| Location                                 | 1 month ago      | 4 months ago      | 4 months ago      | 4 months ago       |
| Leasehold/Fee simple                     | Lawndale Estates | Lawndale Estates  | Lawndale Estates  | Lawndale Estates   |
| Site/View                                | Fee simple       | Fee simple        | Fee simple        | Fee simple         |
| Design (style)                           | .25 acre         | .25 acre          | .25 acre          | .25 acre           |
| Actual age                               | 1 story          | 1 story           | 1 story           | 1 story            |
| Condition                                | 10 years         | 10 years          | 10 years          | 10 years           |
| AG room count                            | Average          | Average           | Average           | Average            |
| Gross living area                        | 8   3   2.5      | 8   3   2.5       | 8   3   2.5       | 8   3   2.5        |
| Basement                                 | 1900             | 1900              | 1900              | 1900               |
| Finished below grade                     | 0                | 0                 | 0                 | 0                  |
| Heating and cooling                      | 0                | 0                 | 0                 | 0                  |
| Garage/Carport                           | GFA/Cent AC      | GFA/Cent AC       | GFA/Cent AC       | GFA/Cent AC        |
| Patios/Decks/Porches, etc.               | 2 car/at/gar     | 2 car/at/gar      | 2 car/at/gar      | 2 car/at/gar       |
| Other                                    | Patio            | Patio             | Patio             | Patio              |
| Net adjustment                           | None             | None              | None              | None               |
| <b>Adjusted sale price of comparable</b> | \$325,000        | \$350,000         | \$375,000         | \$400,000          |

**Table 2 Paired Data Analysis with Adjustments for Concessions**

| Subject                                  | Comparable 1     | Comparable 2          | Comparable 3          | Comparable 4          |
|--|------------------|-----------------------|-----------------------|-----------------------|
| Sale price                               | \$325,000        | \$184,21              | \$197,37              | \$210,53              |
| Sale price/GLA                           | \$171.05         | \$184,21              | \$197,37              | \$210,53              |
| <b>Value adjustments</b>                 |                  |                       |                       |                       |
| Date of sale/time                        | \$ 0 concessions | \$25,000 concess.     | \$50,000 concess.     | \$ 75,000 concess.    |
| Location                                 | 1 month ago      | 4 months ago          | 4 months ago          | 4 months ago          |
| Leasehold/Fee simple                     | Lawndale Estates | Lawndale Estates      | Lawndale Estates      | Lawndale Estates      |
| Site/View                                | Fee simple       | Fee simple            | Fee simple            | Fee simple            |
| Design (style)                           | .25 acre         | .25 acre              | .25 acre              | .25 acre              |
| Actual age                               | 1 story          | 1 story               | 1 story               | 1 story               |
| Condition                                | 10 years         | 10 years              | 10 years              | 10 years              |
| AG room count                            | Average          | Average               | Average               | Average               |
| Gross living area                        | 8   3   2.5      | 8   3   2.5           | 8   3   2.5           | 8   3   2.5           |
| Basement                                 | 1900             | 1900                  | 1900                  | 1900                  |
| Finished below grade                     | 0                | 0                     | 0                     | 0                     |
| Heating and cooling                      | 0                | 0                     | 0                     | 0                     |
| Garage/Carport                           | GFA/Cent AC      | GFA/Cent AC           | GFA/Cent AC           | GFA/Cent AC           |
| Patios/Decks/Porches, etc.               | 2 car/at/gar     | 2 car/at/gar          | 2 car/at/gar          | 2 car/at/gar          |
| Other                                    | Patio            | Patio                 | Patio                 | Patio                 |
| Net adjustment                           | None             | None                  | None                  | None                  |
| <b>Adjusted sale price of comparable</b> | \$325,000        | (25,000)<br>\$325,000 | (50,000)<br>\$325,000 | (75,000)<br>\$325,000 |

**Table 3 Paired Data Analysis with Adjustments for Concessions, Assuming \$75,000 Concessions Included**

|  | <b>Subject</b>     | <b>Comparable 1</b> | <b>Comparable 2</b> | <b>Comparable 3</b> | <b>Comparable 4</b> |
|--|--------------------|---------------------|---------------------|---------------------|---------------------|
| Sale price                               | Refinance          | \$325,000           | \$350,000           | \$375,000           | \$400,000           |
| Sale price/GLA                           | N/A                | \$171.05            | \$184.21            | \$197.37            | \$210.53            |
| <b>Value adjustments</b>                 | <b>Description</b> | <b>Description</b>  | <b>Description</b>  | <b>Description</b>  | <b>Description</b>  |
| Sale-Financing Concessions               | Assume none        | \$ 0 concessions    | \$25,000 concess.   | \$50,000 concess.   | \$ 75,000 concess.  |
| Date of sale/time                        | Now                | 1 month ago         | 4 months ago        | 4 months ago        | 4 months ago        |
| Location                                 | Lawndale Estates   | Lawndale Estates    | Lawndale Estates    | Lawndale Estates    | Lawndale Estates    |
| Leasehold/Fee simple                     | Fee simple         | Fee simple          | Fee simple          | Fee simple          | Fee simple          |
| Site/View                                | .25 acre           | .25 acre            | .25 acre            | .25 acre            | .25 acre            |
| Design (style)                           | 1 story            | 1 story             | 1 story             | 1 story             | 1 story             |
| Actual age                               | 10 years           | 10 years            | 10 years            | 10 years            | 10 years            |
| Condition                                | Average            | Average             | Average             | Average             | Average             |
| AG room count                            | 8   3   2.5        | 8   3   2.5         | 8   3   2.5         | 8   3   2.5         | 8   3   2.5         |
| Gross living area                        | 1900               | 1900                | 1900                | 1900                | 1900                |
| Basement                                 | 0                  | 0                   | 0                   | 0                   | 0                   |
| Finished below grade                     | 0                  | 0                   | 0                   | 0                   | 0                   |
| Heating and cooling                      | GFA/Cent AC        | GFA/Cent AC         | GFA/Cent AC         | GFA/Cent AC         | GFA/Cent AC         |
| Garage/Carport                           | 2 car/at/gar       | 2 car/at/gar        | 2 car/at/gar        | 2 car/at/gar        | 2 car/at/gar        |
| Patios/Decks/Porches, etc.               | Patio              | Patio               | Patio               | Patio               | Patio               |
| Other                                    | None               | None                | None                | None                | None                |
| Net adjustment                           |                    | \$75,000            | \$50,000            | \$25,000            |                     |
| <b>Adjusted sale price of comparable</b> |                    | <b>\$400,000</b>    | <b>\$400,000</b>    | <b>\$400,000</b>    | <b>\$400,000</b>    |

4. The appraiser is required to make market-based adjustments to the comparable sales for any sales or financing concessions that may have affected the sales price. The adjustment for each comparable sale must reflect the difference between the sales price with the sales concessions and what the property would have sold for without the concessions. In the Sales Comparison Analysis, Sales or Financing Concessions Section, the appraiser must report the adjustment applicable to each comparable sale listed

It is clear from this letter that HUD requires adjustments to comparables for any increase in the sale price caused by the favorable treatment of buyers through sales or financing concessions.

### **Conclusion**

To help limit liability and to be compliant with USPAP, it is a best practice for appraisers to specifically indicate if they are including concessions or not. If the appraisal is based on cash or cash equivalent, this also should be stated. If the appraisal is based on assuming concessions are typical, it should so state, as well as how much this contributes to value. Ignor-

ing the issue of sales concessions in the appraisal report is not a good idea. In other words, disclose, disclose, disclose.

**Mark Rattermann, MAI, SRA**, is a senior partner with REsource, LLC, a real estate appraisal firm in Indianapolis. He is active in the Appraisal Institute education program, as both an instructor and course developer. He has received two Appraisal Journal article awards: the Sanders A. Kahn Award in 1994 and the Swango Award in 2005; and in 2007 he received the Appraisal Institute's William N. Kinnard Award for contributions to appraisal education. Rattermann is the author of six books on real estate appraisal, including *Valuation by Comparison: Residential Analysis and Logic*, and *The Student Handbook to THE APPRAISAL OF REAL ESTATE*. **Contact: Education REsource, LLC, 9247 N. Meridian Street, Suite 325, Indianapolis, IN, 46260; T 317-816-9436; E-mail: Mark@educationresource.com**