Introduction

Appraisal and review opinions are often premised on certain stated conditions. These include assumptions (general, and special or extraordinary) and hypothetical conditions. In the case of an assumption, there is uncertainty as to whether or not the condition is true. In the case of a hypothetical condition, there is no uncertainty; the condition presumed true is known to be false. Most often such conditions relate to physical or legal property characteristics, but they may also relate to market characteristics or economic characteristics.

Assumptions and hypothetical conditions are critically important to the appraisal and review processes. For the intended user(s) of the report, they frame the appraisal or review opinion in a specific context. They alert the intended user to outstanding concerns, thereby allowing for informed decision-making. In some cases, when information is lacking or unavailable, their use provides a means by which the assignment can be completed when otherwise it could not.

Valuers and reviewers must understand the nature of assumptions and hypothetical conditions—what they are, how and when they may be used, and how to properly disclose them in appraisal and review reports. Failure to understand the proper use of assumptions and hypothetical conditions—and the implications of their use—puts the valuer or reviewer at risk. Without clear disclosure of them in the appraisal or review report, the intended user(s) of the report could be misled.

What are special/extraordinary assumptions and hypothetical conditions, and how are they properly used in appraisals and reviews?
GUIDE NOTE 15

Applicable Valuation Standards

The Standards of Valuation Practice (SVP) address assumptions and hypothetical conditions in the Definitions section (definitions of hypothetical condition and special assumption), SR A-2(g), SR B-2(e), SR C-2(a)(xvi) and SR C-2(b)(xiii).

Portions of the Appraisal Institute Code of Professional Ethics (CPE) that relate to this topic include ER 3-4 and ER 3-5.

Applicable sections of the Uniform Standards of Professional Appraisal Practice (USPAP) include the Definitions section (definitions of hypothetical condition, and extraordinary assumption); SR 1-2(f) and (g), SR 2-1(c), SR 2-2(a) and (b)(xii); and SR 3-2(f) and 2(f).

Applicable sections of the International Valuation Standards (IVS) include the Definitions section (definition of special assumption); IVS 101 Scope of Work, 20.3(k); and IVS 103 Reporting, 10.2, and IVS Bases of Value, 200.4 and 200.5.

Problem Identification and Scope of Work Determination

Identification of assumptions and hypothetical conditions is part of problem identification, which precedes scope of work determination1. If possible, they are identified prior to acceptance of the assignment. However, sometimes it is not possible to identify them until the valuation or review is underway.

Some clients prefer to be told of assumptions and hypothetical conditions as soon as the valuer or reviewer learns they will be involved. However, a client’s prohibition against use of any special/extraordinary assumption or hypothetical condition might mean that an assignment cannot be completed in cases in which relevant issues are uncertain or the appraisal is to be made contrary to the facts.

The use of assumptions or hypothetical conditions may affect the Scope of Work for an appraisal or review assignment. Scope of Work in turn affects how the valuation or review process is carried out, and that in turn can affect the assignment results (e.g., the value opinion in an appraisal.)

In all cases, the use of an assumption or a hypothetical condition must result in a credible opinion or conclusion, given the intended use.

Conditions Presumed True

Assumptions, special/extraordinary assumptions, and hypothetical conditions involve conditions that are established as true in the appraisal or review process. That is, the appraisal or review conclusion reflects an “as though true” circumstance. In the case of a hypothetical condition, the valuer knows the condition is not true. The condition presumed true is contrary to fact.

In the case of an assumption, the condition may or may not be true; there is uncertainty. In some cases the uncertainty is created because the truth simply is not knowable at the time the appraisal or review is prepared. In other cases, the scope of work—even though determined to be appropriate for the assignment—does not permit the truth about the condition to be known.

Making the distinction between a special/extraordinary assumption and a “general” assumption can be difficult. Both are conditions presumed true when in fact they might not be true. For both if the condition proves false the opinions and conclusions (e.g., a value conclusion) could be impacted. Both require disclosure in the report, but special/extraordinary assumptions require more conspicuous disclosure; they must be emphasized. However, in the case of a general assumption, while there is uncertainty as to whether or not the condition is true, there is no readily apparent reason why it would not be. In the case of a special/extraordinary assumption, the valuer spots a “red flag”, something that alerts the valuer to the possibility that the condition might not be true.

The following examples show the distinction among general assumptions, special/extraordinary assumptions, and hypothetical conditions:

Example 1: A valuer is asked to value an improved property that has a known construction defect, but because the appraisal is for purposes of settling a dispute, the client requests the property be valued as though there is no such defect. In this case, the value opinion reflects no defect and the appraisal is based on the hypothetical condition that there is no defect.

Example 2: A valuer is asked to value an improved property that may have a construction defect. The valuer observes signs of settlement, or perhaps an individual familiar with the property indicates there may be a construction defect. The value opinion reflects no defect and the appraisal is based on the special/extraordinary assumption that there is no defect.

Example 3: A valuer is asked to value an improved property. There is no reason to believe there are any construction defects; the valuer is not told of any and there are no readily apparent reasons to believe there are any. The appraisal report might include a general assumption that there are no construction defects.

In example 1, the intended use calls for the appraisal to be based on the hypothetical condition. While the use of the hypothetical condition is anticipated, its clear disclosure in the report frames the value opinion in the proper context so the intended user(s) are not misled.

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1 Problem identification for an appraisal is required in the SVP under SR A-2 and in USPAP under Standards Rule 1-2(a)(g), and for a review in the SVP under SR B-2 and in USPAP under Standards Rule 3-2(a)(g). Scope of Work determination is required in the SVP under SR A-3 and in USPAP under 1-2(h), and for a review in the SVP under SR B-3 and in USPAP under Standards Rule 3-2(h).
In example 2, clear disclosure of the special/extraordinary assumption in the report will alert the client to the uncertainty about a possible construction defect and the fact that the value opinion does not take into account the impact of any such defect, should there be one. The client can then make the decision to investigate the situation further, or to rely on the appraisal based on the special/extraordinary assumption.

In example 3, there is nothing alerting the valuer to a possible problem relating to construction defects. If there were, the assumption would rise to the level of an extraordinary or special assumption.

Impact of Effective Date

In the case of both assumptions and hypothetical conditions, the condition presumed true is so presumed as of the effective date (or date of value, in an appraisal), not before or after.

For example, a property is zoned for residential use, but a zoning change to commercial use is likely in the future. If the property is valued as of a current effective date as though it is already re-zoned for commercial use, the value is premised on the hypothetical condition that the re-zoning has taken place as of the effective date, not on the special or extraordinary assumption that it will be re-zoned after the effective date. When market participants perceive that a property would likely be re-zoned in the near future, the current value of that property may reflect that perception; i.e., the value might be higher (or lower) because of the likelihood of the zoning change, though not as high (or low) as the value based on the hypothetical condition that the zoning change had already occurred on the date of value.

Similarly, consider the case in which the leased fee interest in a property is being valued but as of the current effective date the lease is not signed. If the valuer is asked to value the property as though the lease is signed, such value would either be a current value premised on the hypothetical condition that the lease is signed, or a prospective value premised on the special/extraordinary assumption that the lease will be signed as of the future date of value.

Impact on the Valuation Process

Assumptions and hypothetical conditions are established at the beginning of the valuation process (or review process, in the case of a review) and the valuation proceeds from that basis. For example, a hypothetical condition is established at the beginning of an assignment that the improvements are constructed as of the effective date (when in fact the site is vacant.) The highest and best use of the property “as if improved” must then be considered. The approaches to value would provide indications of the value of the property “as if improved.”

Or consider the case in which the hypothetical condition is established that the zoning has been changed to allow industrial use. In the highest and best use analysis, the consideration of legally permissible use would recognize industrial use as a legal use, and so the conclusion of highest and best use would be impacted by the hypothetical condition.

As another example, an appraisal is to be developed without benefit of an interior inspection of the building, so the special/extraordinary assumption is established at the beginning of the valuation process that the building consists of 5,000 square feet and is in good condition. From that point forward in the valuation process, the subject is a 5,000 square foot building in good condition. It would be improper, for example, when performing the sales comparison approach, to change the characterization of the building from what it was assumed to be.

If the Condition is False or Proves to be False

An appraisal is not inherently flawed because it is premised on a hypothetical condition. An appraisal or review is not erroneous because it is premised on a special or extraordinary assumption and the condition presumed true subsequently proves to be false. Unless the valuer or reviewer has agreed with the client otherwise, the valuer or reviewer is not obligated to amend an appraisal or review if the condition presumed true subsequently proves to be false.

Importance of Clear Disclosure

The use of an assumption or hypothetical condition has critical significance to both the development and reporting of an appraisal or review. From a development standpoint, their use impacts the entire valuation or review process, as well as the value or review opinion. But the appraisal or review report—whether written or oral—is the means by which the valuer conveys his or her findings to the client. From a reporting standpoint, their clear disclosure is necessary in order to not be misleading.

The SVP and USPAP require “clear and conspicuous” disclosure of special/extraordinary assumptions and hypothetical conditions, along with the statement that their use might have affected the opinions and conclusions. This statement must be phrased carefully so as to not inadvertently express another value opinion. For example, a statement that “the value would be higher” if it were not premised on a hypothetical condition is in itself an opinion of value (appraisal) that must be developed and reported according to the applicable standards.

There is no requirement in the SVP, USPAP or IVS to provide an appraisal or review opinion that is not based on the special/extraordinary assumption or hypothetical condition when one is used.
There is no requirement in the SVP, USPAP or IVS to use the labels “extraordinary assumption”, “special assumption” or “hypothetical condition.” If they are used, they must be used correctly. It is generally advisable to use the terms and note that they are defined in the applicable standards.

In reports with more than one value opinion (for example, a current value as well as a prospective value upon completion) it is important that the special/extraordinary assumption(s) and/or hypothetical condition(s) be linked to the value opinion or opinions to which they pertain. The report must be clear about which special/extraordinary assumption or hypothetical condition pertains to which value opinion(s).

The disclosure of a special/extraordinary assumption or hypothetical condition must be clear about what condition is being presumed to be true. For example, the statement “I did not inspect the interior of the building” is a statement about scope of work, not an assumption or hypothetical condition.

Often the use of a special/extraordinary assumption or hypothetical condition is intricately linked to the scope of work for an assignment, and so it is logical to place the discussion of them together in the report. For example, the scope of work for an appraisal might not include an inspection by the valuer of the interior of the subject improvements. Or the scope of work for a review might include the reviewer providing his or her own opinion of value, but not include an inspection of the property. These situations give rise to the valuer or reviewer making extraordinary or special assumptions about the nature of the subject’s improvements (condition, etc.) In both cases the discussion of scope of work and the discussion of the special/extraordinary assumption should go hand in hand so that the intended user(s) of the report understand(s) the connection.

There is no standards or ethics requirement to include the discussion about assumptions and hypothetical conditions in any particular portion of an appraisal or review report. The requirement is simply to clearly and conspicuously disclose special/extraordinary assumptions and hypothetical conditions and state that their use might have affected the opinions and conclusions. While there is no requirement to state them in an appraisal report wherever the value opinion is stated, in lengthy reports it might be advisable to state them more than once. Another good practice may be to include a full discussion of them in one section of the report, and then refer to that discussion using an asterisk with a reference note wherever the value opinion is stated (such as in the letter of transmittal, executive summary, or reconciliation section.)

**As Is” Values**

Care must be taken when using the phrase “as is” to describe a value opinion. It is misleading to identify a value premised on a hypothetical condition as an “as is” value, because the use of a hypothetical condition makes the value “as if” and contrary to what exists. If a value is premised on a special or extraordinary assumption, it may or may not be an “as is” value. Unless and until the uncertainty that created the need for the special or extraordinary assumption is removed, the value should not be characterized as “as is.”

If a valuer is asked to provide a value “as is” and cannot because such value would be premised on a hypothetical condition, or would be premised on a special/extraordinary assumption due to an uncertainty, the valuer should consult with the client about how the assignment should proceed. In some cases, the only way for the valuer to provide an “as is” value is to delay the appraisal until the condition that created the need for a hypothetical condition has been changed, or until more information is made available so that the uncertainty creating the need for the special/extraordinary assumption has been removed.

For example, a client requests an “as is” market value for a 1-acre lot that is not currently a legal lot, but will be upon subdivision of a larger 5-acre lot, which is anticipated when the sale closes in 30 days. A current value of the 1-acre lot would be premised on the hypothetical condition that the lot has already been subdivided, when in fact it has not been, and this would not be an “as is” value. The valuer and client should discuss the possibility of providing a prospective value as of 30 days from now premised on the special/extraordinary assumption that the lot will be legally subdivided on that date. The report would include the appropriate disclosure, which would serve to alert the client to consider taking certain actions regarding the subdivision—for example, ensuring the subdivision has been finalized before closing a loan.

Or, consider the case in which the valuer believes the subject site might be contaminated, but does not know that for certain. The appraisal may be completed on the basis of the special/extraordinary assumption that it is not contaminated. The value may or may not be “as is”; until the uncertainty is removed, it cannot be determined. Alternatively, the client could agree to place the appraisal “on hold” until the valuer is provided with information that ascertains whether the site is or is not contaminated; once that information is obtained, the appraisal can be completed without need for a special/extraordinary assumption because the uncertainty has been removed.

In some cases, it may be impossible to provide a value that is not premised on a special/extraordinary assumption. For example, the subject improvements are damaged, and the valuer is provided with an estimate from a construction expert of the cost to repair the damage. The appraisal relies on the construction cost expert’s estimate to arrive at the current value. The appraisal would be premised on the special/extraordinary assumption that the construction cost expert’s estimate is accurate. Proper disclosure of this special/extraordinary assumption in the report alerts the client to the fact that if the construction cost estimate is inaccurate, the value conclusion might not be credible. The client can then make the decision to rely on the appraisal or not, given the special/extraordinary assumption.

Note: Appraisals prepared for U.S. federally regulated lenders generally require an “as is” market value. This term is defined by the regulatory agencies’ Interagency Appraisal and Evaluation Guidelines as “The estimate of the market value of real property in its current physical condition, use, and zoning as of the appraisal’s effective date.” Valuers preparing appraisals for U.S. regulated lenders that include a value according to this definition should follow the guidance from the regulatory agencies regarding interpretation of it, especially with respect to the use of extraordinary assumptions, as interpretations may vary.
Special or extraordinary assumptions and hypothetical conditions occur in a variety of appraisal circumstances. The following examples are not all-inclusive.

**Proposed construction:**

Example A:

The subject property currently consists of a vacant site. The value opinion reflects the property as though the proposed improvements are complete as of the date of value, which is the current date. This value is premised on the hypothetical condition that the improvements as proposed are complete on the date of value. The appraisal report would need to discuss the nature of the proposed improvements, include a clear disclosure of the hypothetical condition, and state that its use might have affected the opinions and conclusions.

Example B:

The subject property currently consists of a vacant site. The value opinion reflects the property as though the proposed improvements are complete as of the date of value, which is a future (prospective) date. This value is premised on the special or extraordinary assumption that the improvements as proposed will be complete on the date of value. This value would also be premised on the general assumption that there will be no unforeseen circumstances that would cause market conditions to significantly differ from what is anticipated. The appraisal report would need to discuss the nature of the proposed improvements, include a clear disclosure of the special or extraordinary assumption, and state that its use might have affected the opinions and conclusions. Note that this example differs from Example A only in that the date of value is a future vs. a current date. The condition presumed true (that the improvements are complete on the date of value) is a special/extraordinary assumption rather than a hypothetical condition because the future is inherently uncertain.

**Occupancy level:**

Example C:

The subject property currently consists of the leased fee interest in a multi-tenant facility. The value opinion reflects the property as though at stabilized occupancy as of the date of value, which is the current date. This value is premised on the hypothetical condition that the property is at stabilized occupancy on the date of value. The appraisal report would need to discuss what is meant by “stabilized occupancy”, include a clear disclosure of the hypothetical condition, and state that its use might have affected the opinions and conclusions.

Example D:

The subject property currently consists of the leased fee interest in a multi-tenant facility. The value opinion reflects the property as though at stabilized occupancy as of the date of value, which is a future (prospective) date. This value is premised on the special or extraordinary assumption that the property is at stabilized occupancy on the date of value. This value would also be premised on the general assumption that there will be no unforeseen circumstances that would cause market conditions to significantly differ from what is anticipated. The appraisal report would need to discuss what is meant by “stabilized occupancy”, include a clear disclosure of the special or extraordinary assumption, and state that its use might have affected the opinions and conclusions.

Again, note that this example differs from Example C only in that the date of value is a future vs. a current date. The condition presumed true (that the property is at stabilized occupancy) is a special/extraordinary assumption rather than a hypothetical condition because the future is inherently uncertain.

**Miscellaneous property condition issues**

A variety of other possible or actual property condition issues give rise the need for assumptions or hypothetical conditions:

Example E:

The subject property is not connected to the municipal sewer system but the intended use of the appraisal calls for it to be valued as though it is. The value opinion reflects the property as though it is connected to the sewer system as of the date of value, which is the current date. This value is premised on the hypothetical condition that the property is connected to the sewer system on the date of value. The appraisal report would need to include a clear disclosure of the hypothetical condition and state that its use might have affected the opinions and conclusions. (If the date of value were a future date, the condition would be a special/extraordinary assumption rather than a hypothetical condition.)

Example F:

It is uncertain on the date of value whether a particular use is permitted on the subject property. The value opinion reflects the property as though the use is permitted as of the date of value, which is the current date. This value is premised on the special/extraordinary assumption that the use is permitted on the date of value. The appraisal report would need to include a clear disclosure of this special/extraordinary assumption and state that its use might have affected the opinions and conclusions.

Example G:

The subject property is located in an area that is known to have unstable soils. However, it is uncertain whether the subject property’s soils are stable or unstable. The value opinion reflects the property as though soils are stable on the date of value, which is the current date. This value is premised on the special/extraordinary assumption that the soils are stable. The appraisal report would need to include a clear disclosure of this special/extraordinary assumption and state that its use might have affected the opinions and conclusions.
Example H:
The subject property is the former site of a heavy industrial use and the valuer is aware that the site might be contaminated, but
this is not known for certain. The value opinion reflects the property as though the subject site is not contaminated on the date of
value, which is the current date. This value is premised on the special/extraordinary assumption that the site is not contaminated.
The appraisal report would need to include a clear disclosure of this special/extraordinary assumption and state that its use might have affected the opinions and conclusions.

Example I:
The subject property is a large, irregularly shaped parcel located in a rural area. Neither a physical inspection nor the legal
description provided to the valuer can clarify whether the parcel has legal access. It appears the only access is across the adjacent
site. The valuer is told the adjacent property owner granted an easement for access but is unable to confirm this. The value opinion
reflects the property as though the subject site has legal access on the date of value, which is the current date. This value is
premised on the special/extraordinary assumption that the site has legal access. The appraisal report would need to discuss the
nature of the presumed access, include a clear disclosure of the special/extraordinary assumption, and state that its use might have affected the opinions and conclusions.

Example J:
The subject property is the fee simple interest in a 5-acre portion of a 20-acre parcel. The 5 acres is not a legal parcel. The
market value opinion reflects the property as though it is a legal parcel on the date of value, which is the current date. This value is
premised on the hypothetical condition that the parcel is a legal parcel. The appraisal report would need to include a clear
disclosure of the hypothetical condition and state that its use might have affected the opinions and conclusions.

Example K:
The subject property is the fee simple interest 123 Main St., which is a 2 acre parcel improved with a single family residence and a
5,000 square foot commercial building. The client requests the property be appraised as though the commercial building does not
exist. The value opinion reflects the property as though the commercial building does not exist on the date of value, which is the
current date. This value is premised on the hypothetical condition that the commercial building does not exist. The appraisal report
would need to include a clear disclosure of the hypothetical condition and state that its use might have affected the opinions and conclusions.

Example L:
An appraisal is prepared for eminent domain purposes, so the “before” value must not take into account project influence and
the “after” value must reflect the property as though the proposed project has been completed. The “before” value is premised
on the hypothetical condition that the project is not proposed. If the “after” value is a prospective value, it is premised on the
special/extraordinary assumption that the project will be completed as proposed, and the general assumption that there will be no
unforeseen circumstances that would cause market conditions to significantly differ from what is anticipated. If the “after” value is
a current value, it is premised on the hypothetical condition that the project is completed as proposed. The appraisal report
would need to include a clear disclosure of the special/extraordinary assumption(s) and/or hypothetical condition and state that their use
might have affected the opinions and conclusions.

Reliance on the work of another:

Example M:
An appraisal involving proposed improvements relies on the construction cost estimate provided by an engineer. The “red flag” goes
up by virtue of the fact that the valuer does not possess the expertise to evaluate the accuracy of the cost estimate. The value
opinion is premised on the special/extraordinary assumption that the cost estimate is accurate. The appraisal report would need
to include a clear disclosure of the special/extraordinary assumption, and state that its use might have affected the opinions and conclusions.

Example N:
Valuer 1 has expertise in valuing partial interests, but lacks market area competency to appraise the 100% interest in a property.
Valuer 2 has the expertise, including market area competency, to appraise the 100% interest in the same property. Valuer 1’s
appraisal of the partial interest relies on Valuer 2’s appraisal of the 100% interest. (Valuer 2 does not sign Valuer 1’s appraisal
report.) Valuer 1’s value opinion (of the partial interest) is premised on the special/extraordinary assumption that Valuer 2’s value
opinion is credible. Valuer 1’s appraisal report would need to include a clear disclosure of the special/extraordinary assumption,
and state that its use might have affected the opinions and conclusions.

Review Examples

A review results in an opinion of the quality of the work under review. Depending on the needs of the client and the scope of work for the
assignment, a review assignment might also include the reviewer’s own opinion of value.

If the reviewer provides his or her own opinion of value in the review assignment, the reviewer’s opinion of value may be premised on
assumptions or hypothetical conditions. Consider the following examples (they are not all-inclusive).
Example O:
The reviewer has determined that the scope of work need not include inspecting the subject of the appraisal. The reviewer agrees with the value in the appraisal report under review. The reviewer’s opinion of value is premised on the special/extraordinary assumption that the description of the property in the appraisal report is accurate.

Example P:
The reviewer has determined that the scope of work need not include researching the market data relied upon in the appraisal under review. The reviewer agrees with the value in the appraisal report under review. The reviewer’s opinion of value is premised on the special/extraordinary assumption that the market data presented in the appraisal report is accurate and represents the best available data.

Example Q:
The reviewer agrees with the value in the appraisal report under review. That value is premised on the hypothetical condition that the improvements are complete as proposed on the effective date, which is the current date. The reviewer’s opinion of value is likewise premised on the same hypothetical condition.

Summary of Standard Practices

1. When assignment conditions such as special/extraordinary assumptions or hypothetical conditions are labeled in a report, they must be labeled correctly.

2. Special/extraordinary assumptions or hypothetical conditions are conditions presumed true on the effective date, e.g., date of value for an appraisal, not before or after.

3. Special/extraordinary assumptions or hypothetical conditions must be clearly and conspicuously disclosed in a written or oral appraisal or review report so that the intended user(s) of the report clearly understand the context of the appraisal or review conclusions. In addition, the report must include the statement that the use of the special/extraordinary assumption or hypothetical condition might have affected the opinions and conclusions.

4. It is misleading to characterize a value opinion based on a hypothetical condition as an “as is” value. A value opinion based on a special/extraordinary assumption may or may not be “as is.” Care must be taken when using the phrase “as is” in connection with a value opinion.

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