
THE APPRAISAL OF REAL ESTATE

Tenth Edition



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Published 1951. Tenth edition 1992.

Printed in the United States of America

97 96

7 6 5 4

The photos appearing in this text were supplied by H. Armstrong Roberts, Inc. and HISTORICAL PICTURES/STOCK MONTAGE

Library of Congress Cataloging-in-Publication Data

The Appraisal of real estate. — 10th ed.

p. cm.

Includes bibliographical references and index.

ISBN 0-922154-04-X

1. Real property—Valuation. 2. Personal property—Valuation.

I. Appraisal Institute (U.S.)

HD1387.A663 1992

333.33'2—dc20

92-8824

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The Appraisal of Real Estate

FOREWORD

Real estate appraisal is a highly dynamic profession even in the most ordinary of times. Market conditions are always in flux, and real estate investors and underwriters must periodically reexamine their expectations. The theory and practice of appraisal continue to evolve in response to the changing concerns and behaviors of market participants. The technology available to appraisers expands as computerized applications and databases are developed. If change typifies the appraisal field in normal periods, the late 1980s and early 1990s have witnessed an extraordinary volume of events affecting the appraisal profession. The entire working environment of appraisers has recently been altered by the impact of new legislation and regulation. In today's unpredictable economy, it is absolutely essential for appraisers to keep up with current developments and to incorporate the latest concepts into their work.

To meet the needs of both seasoned practitioners and students entering the field, *The Appraisal of Real Estate* has been extensively revised and updated to address current concerns. I am especially pleased, therefore, to introduce the tenth edition to appraisal professionals of the 1990s. The tenth edition provides state-of-the-art analysis and discussion of the appraisal process and the three approaches to value. New topics covered include state licensing and certification, legislation affecting appraisers, professional liability, review appraisal, environmental hazards, recent monetary policy, and ongoing events in the thrift industry. Of the wealth of data collected for the 1990 census, the GIS database and TIGER files are specifically highlighted for their usefulness to real estate research. Market analysis, which has become increasingly important within the appraisal field, has received expanded coverage. Where relevant, the tenth edition also reflects the provisions and usage in the Standards of Professional Appraisal Practice of the Appraisal Institute.

The Appraisal Institute would like to especially acknowledge the dedicated work of Howard C. Gelbtuch, MAI, Chair of the Publications Committee, and Paula O. Thoreen, MAI, Chair of the Textbook and Dictionary Revision Committee. Both of these individuals guided the extensive decision-making process required to ensure that the content of the tenth edition is useful and current. I would also like to thank the many developers and reviewers for their contributions to the project: Charles B. Akerson, MAI; Norman R. Benedict, MAI; Robert C. Cantwell IV, MAI; David Cavanaugh; David W. Childers, MAI; William Lowell Christensen, MAI, SRA; Carlton W. Cole, MAI; Winfield L. Cooper, SRA; Max J. Derbes, Jr., MAI; John D. Dorchester, Jr., MAI; J.D. Eaton, MAI; Alfred J. Ferrara, MAI, SRA; Clifford F. Fisher, Jr., MAI; Jeffrey D. Fisher, PhD; Kenneth G. Foltz, MAI; Robert L. Foreman, MAI; W. West Foster, MAI; Kathryn Mason Gearheard, MAI; James E. Gibbons, MAI; Richard E. Hanton, MAI; Frank E. Harrison, MAI, SRA; Stephen J. Hobbs, SRPA, SRA; David J. Lau, MAI; Mark L. Levine, MAI, PhD; A. Scruggs Love, Jr., MAI, SRA; Kenneth M. Lusht, SRPA, PhD; Richard Marchitelli, MAI; James J. Mason, MAI; C. David Matthews, MAI, SRA; J. Virginia Messick, MAI; Bill Mundy, MAI, PhD; Terrell R. Oetzel, MAI; Robert L. Parson, MAI; David A. Pearson, MAI; Joseph Rabianski, PhD; Charles W. Rex III, MAI; Anthony Reynolds, MAI; Judith Reynolds, MAI; Thomas L. Roberts, MAI; Felice A. Rocca, MAI; Alan M. Schmook, MAI, SRA; Lee B. Smith, MAI; Richard C. Sorenson, MAI; Richard L. Stallings, MAI, SRA; Lloyd Stebbins, PE;

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Chapter 1

REAL PROPERTY AND ITS APPRAISAL

Under all is the land. This statement implies more than a physical reality. Land is the surface of the earth and the source of all minerals, vegetable matter, and animals. It is the foundation for the social and economic activities of people as well as a commodity and source of wealth.

Because land is essential to life and society, it is the subject of various disciplines, including geography, law, sociology, and economics. Each of these disciplines employs a somewhat different concept of real estate. Geography focuses on describing the physical elements of land and the distribution and activities of the people who use it. In law the ownership of land is considered. Sociology focuses on the dual nature of land: as a resource to be shared by all people and a commodity to be owned, traded, and used by individuals. In economics, land is regarded as one of the four agents of production, along with labor, capital, and coordination. Land represents all the natural elements of a nation's wealth.

Land value is an economic concept. A common understanding of the attributes of land is shared by geographers, lawyers, sociologists, and economists.

1. Each parcel of land is unique in its location and composition.
2. Land is physically immobile.
3. Land is durable.
4. The supply of land is finite.
5. Land is useful to people.

Real estate appraisers also recognize these attributes of land. They are concerned with the concepts of land used in other disciplines because these concepts provide the basic perceptions on which real estate value rests. In real estate appraisal the emphasis is on real estate markets, which result from the actions of people who respond to, and often are directed or limited by, all the important attributes of land delineated in other disciplines.

CONCEPTS OF LAND

Geographic

An understanding of land begins by recognizing its diverse physical characteristics and how these characteristics combine in a particular area. Developing a sense of land includes an awareness of how physical characteristics influence the use of land.

Land is affected by a number of processes. Ongoing physical and chemical processes modify the land's surface, biological processes affect the distribution of life forms, and socioeconomic processes direct human habitation and activity on the land. Together, these processes influence the characteristics of land and, therefore, land use.

Land may be used for many purposes, including agriculture, commerce, industry, habitation, and recreation. Land-use decisions are influenced by climate, topography, and the distribution of natural resources, population centers, and industry. Land use is also affected by economic conditions, population pressures, technological practices, and cultural influences. The influence of each of these factors varies depending on the geographic area.

Geographic considerations are particularly significant to appraisers. The importance of land's physical characteristics—e.g., climate, geology, soils, water, and

vegetation—is obvious, but the distribution of people, facilities, and services and the movement of goods and people are equally important. The geographic concept of land, which emphasizes matters such as resources and resource bases, the location of industry, and actual and potential markets, provides much of the background knowledge required in real estate appraisal.

Legal

The cultural, political, governmental, and economic attitudes of a society are reflected in its laws. The legal profession does not focus on the physical characteristics of land, but on the rights and obligations associated with various interests in land. Under the law the right of individuals to own and use land for material gain is maintained, while the right of all people to use the land is protected. In other words, the law recognizes the possible conflict between private ownership and public use.

“Whose is the land, his it is, to the sky and the depths.” This ancient maxim is the basis of the following legal definition:

Land includes not only the ground, or soil, but everything that is attached to the earth, whether by course of nature, as are trees and herbage, or by the hand of man, as are houses and other buildings. It includes not only the surface of the earth, but everything under it and over it. Thus, in legal theory, a tract of land consists not only of the portion on the surface of the earth, but is an inverted pyramid having its tip, or apex, at the center of the earth, extending outward through the surface of the earth at the boundary lines of the tract, and continuing on upward to the heavens.¹

This definition may seem to suggest that land ownership includes complete possession of land from the center of the earth to the ends of the universe. In practice, however, ownership is limited. For example, the U.S. Congress has declared that the federal government has complete and exclusive sovereignty over the nation's airspace and that every citizen has “a public right to freedom of transit in air commerce through the navigable air space of the United States.”² Because land ownership can be limited, ownership rights are the subject of law, and the value of these rights is the subject of real estate appraisal.

The laws that govern the use and development of land in the United States give the landowner the greatest possible freedom to decide how to use the land. The owner's rights are restricted only if they unreasonably harm the rights of others. The definition of reasonable use has been argued in many court cases.

Legal matters of particular concern to appraisers include easements, access regulations, use restrictions, and the recording and conveyance of titles. Real estate appraising involves the valuation of real property rights, which are defined by local and state law. Appraisers must be familiar with local and state law because jurisdiction over land is vested primarily at local and state levels.

1. Robert Kratovil and Raymond J. Werner, *Real Estate Law*, 8th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1983), 6.

2. The Air Commerce Act of 1926 (formerly 49 USC 171 *et seq.*); the Civil Aeronautics Act of 1938 (formerly 49 USC 401 *et seq.*); and the Federal Aviation Act of 1958 (see 49 USC 401).

Social

As the physical characteristics and legal limitations of land increasingly affect its use, society has become concerned with how land is used and how rights are distributed. The supply of land is fixed, so increased demand for land exerts pressure for land to be used more intensively. Conflicts often arise between groups with different views on proper land use. Some people believe that land is a resource to be shared by all. They want to preserve the land's scenic beauty and important ecological functions. Others view land primarily as a marketable commodity; they believe that society is best served by private, unrestricted ownership. Because land is both a resource and a commodity, there are no clear-cut solutions to this conflict.³

Both points of view have legal support. As a resource, land is protected for the good of society. As a marketable commodity, the ownership, use, and disposal of land are regulated so that individual rights are not violated.

In 1876 the U.S. Supreme Court established government's right to regulate "the manner in which [a citizen] shall own his own property when such regulation becomes necessary for the public good." The court quoted the words of England's Lord Chief Justice Hale: "When private property is 'affected with a public interest,' it ceases to be *juris privati* only."⁴ Throughout American history, land ownership has been recognized as fundamental. John Adams wrote, "If the multitude is possessed of real estate, the multitude will take care of the liberty, virtue, and interest of the multitude in all acts of government."⁵

In the public interest, society may impose building restrictions, zoning and building ordinances, development and subdivision regulations, and environmental controls. Environmental controls include provisions to protect the air and water from wastes, dirt, chemicals, and excessive noise. To preserve land in its natural state, there are regulations that protect wetlands, beaches, and navigable waters. Real estate appraisers must be familiar with the regulations and restrictions that apply to the use of a property and understand the way in which these regulations are enforced.

Economic

Land is a physical substance with inherent ownership rights that can be legally limited for the good of society. Land is also a major source of wealth which, in economic terms, is measured in money or exchange value. Land and its products have economic value only when they are converted into goods or services that are useful, desirable, and paid for by consumers. The economic concept of land as a source of wealth and an object of value is central to appraisal theory.

The economic concept of land reflects a long history of thought on the sources and bases of value, which is referred to as *value theory*.⁶ Value theory contributes to the definitions of value used in appraisal reports and appraisal liter-

3. Richard N. L. Andrews, *Land in America* (Lexington, Mass.: D.C. Heath and Company, 1979), ix.

4. 94 U.S. 113 (1896). Quoted in "Land as a Commodity 'Affected with a Public Interest'" by Richard F. Babcock and Duane A. Feurer in Richard N. L. Andrews' *Land in America* (Lexington, Mass: D.C. Heath and Company, 1979), 110.

5. *Ibid.*, 31.

6. Paul F. Wendt, *Real Estate Appraisal: Review and Outlook* (Athens: University of Georgia Press, 1974), 17.

ature, and it is an important part of the philosophy on which professional appraisal practice is founded. The development of value theory and its relationship to other systems of thought, which form the ideological basis for real estate appraisal, are discussed in Chapter 2.

THE DISCIPLINE OF APPRAISAL

Geographic, legal, social, and economic considerations all relate to the real estate appraiser's concept of land. Land, legally defined to include everything attached to the land, constitutes real estate. Appraisers study the value of physical real estate and its accompanying ownership rights, recognizing that real estate exists within the context of our society as a whole. Because the potential uses of land are influenced by geographic, legal, social, and economic factors, these considerations form the background against which appraisal activities are conducted.

REAL ESTATE, REAL PROPERTY, AND PERSONAL PROPERTY

To begin the study of real estate appraisal, an important distinction must be made between the terms *real estate* and *real property*. Although these concepts are different, some state laws treat them as synonymous.

Real estate is the physical land and appurtenances affixed to the land, e.g., structures. Real estate is immobile and tangible. The legal definition of real estate includes land and all things that are a natural part of land (e.g., trees, minerals) as well as all things that are attached to it by people (e.g., buildings, site improvements). All permanent building attachments (e.g., plumbing, electrical wiring, heating systems) as well as built-in items (e.g., cabinets, elevators) are usually considered part of the real estate. Real estate includes all attachments, both below and above the ground.

Real property includes all interests, benefits, and rights inherent in the ownership of physical real estate. A right or interest in real estate is also referred to as an *estate*. Specifically, *an estate in land is the degree, nature, or extent of interest that a person has in it.*

Interests vary, so real property is said to include a “bundle of rights” that are inherent in the ownership of real estate. Ownership rights include the right to use real estate, to sell it, to lease it, to enter it, to give it away, or to choose to exercise all or none of these rights. The bundle of rights is often compared to a bundle of sticks, with each stick representing a distinct and separate right or interest. Private enjoyment of these rights is guaranteed by the U.S. Constitution subject to certain limitations and restrictions, which are discussed below.

It is possible to own all or only some of the rights in a parcel of real estate. The extent of ownership determines the kind of interest, or estate, that is held. A person who owns all the property rights is said to have *fee simple title*. *A fee simple estate implies absolute ownership unencumbered by any other interest or estate.* Partial interests in real estate are created by selling, leasing, or otherwise limiting the bundle of rights in a fee simple estate. Partial estates include leased fee and leasehold estates.

A leased fee estate is an ownership interest held by a landlord with the right of use and occupancy conveyed by lease to others; the rights of the lessor (the leased fee owner) and the leased fee are specified by contract terms contained

within the lease. In the appraisal of income-producing property, the leased fee estate is the most frequently valued property interest. An appraisal assignment may call for the appraisal of a fee simple estate or a partial interest such as a *leasehold estate, which is held by a lessee (the tenant and renter) and conveys the right of use and occupancy for a stated term under certain conditions.* (A detailed discussion of the valuation of partial interests is presented in Chapter 6.)

All estates in real property are subject to, and limited by, the four powers of government: taxation, eminent domain, police power, and escheat.

Taxation is the right of government to raise revenue through assessments on valuable goods, products, and rights. Because the U.S. Constitution effectively precludes the federal government from taxing real property directly, the right of taxation is reserved for state and local governments.

Eminent domain is the right of government to take private property for public use upon the payment of just compensation. This right can be exercised by an entity acting under governmental authority such as a housing authority or public utility. *Condemnation is the act or process of enforcing the right of eminent domain.*

Police power is the right of government under which property is regulated to protect public safety, health, morals, and general welfare. Zoning ordinances, use restrictions, building codes, air and land traffic regulations, access rights, and health regulations are based on police power.

Escheat is the right of government that gives the state titular ownership of a property when its owner dies without a will or any ascertainable heirs. The government also controls *overflight, the air space over a property through which aircraft may pass so long as the property's occupants suffer no inconvenience beyond established standards.*

In addition to government restrictions on property, private legal agreements may also impose limitations. One type of agreement is a restriction inserted in a

ARTICLE V.

Provisions concerning Prosecution, Trial and Punishment—Private Property Not to Be Taken for Public Use, Without Compensation.

No person shall be held to answer for a capital or other infamous crime unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the militia, when in actual service, in time of war or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use without just compensation.

The Fifth Amendment to the U.S. Constitution requires the payment of just compensation whenever private property is taken for public use.

deed. Private restrictions can limit the use or manner of development and even the manner in which ownership can be conveyed. The purchaser of a property may be obligated to use the property subject to a private restriction such as an easement, right-of-way, or party-wall agreement.

The individual rights in the bundle of rights can be sold, leased, transferred, or otherwise disposed of separately, subject to government limitations and private restrictions. Owners of certain parcels of land have a number of options. For example, one property owner could sell or lease the mineral rights to his property and retain the rights to use the surface area. Another owner could lease the property's surface rights to one party and the subsurface rights to another. Owners can also sell or lease the air rights to a property for construction or aviation (i.e., air traffic control). Thus, certain rights can be severed from the ownership of a property and be sold, leased, or given to others.

Appraisers must not only understand the distinction between real estate and real property, but they must also differentiate between *real estate* and *personal property*. *Personal property includes movable items of property that are not permanently affixed to, or part of, the real estate.* Personal property is not endowed with the rights of real property ownership. Examples of personal property are furniture and furnishings such as refrigerators and freestanding shelves that are not built into the structure. Under specific lease terms, items such as bookshelves and venetian blinds may be installed in a leased property by the tenant and remain personal property to be removed at the termination of the lease.

Although personal property generally consists of tangible items, called *chattels personal*, an intangible personal property right, called *chattels real*, may be created by a lease.⁷

It is sometimes difficult to determine whether an item should be considered personal property or real estate. Often, the courts must resolve such a conflict. A *fixture is an article that was once personal property, but has since been installed or attached to the land or building in a rather permanent manner; it is regarded in law as part of the real estate.* Therefore, a fixture is endowed with the rights of real property ownership and is part of the real estate. Indeed, the components of all real estate improvements were once personal property. When attached to the land, they become real estate.

Although fixtures are real estate, trade fixtures are not. A *trade fixture, also called a chattel fixture, is an article that is owned and attached to a rented space or building by a tenant and used in conducting a business.* Thus, trade fixtures are not real estate endowed with the rights of real property ownership; they are personal property regardless of how they are affixed.

Some examples of trade fixtures are restaurant booths and bars, gasoline station pumps and storage tanks, and the body building equipment in a health club. In industrial real estate, the term can be used to refer to fixed building equipment installed for human comfort (e.g., plumbing, lighting, heating, air-conditioning) and to industrial equipment (e.g., air hoses, water pipelines, craneways, bus

7. Historically, ownership rights to real estate for a fixed number of years, such as a tenant's interest, were considered personal property. These rights were called *chattels real*, to distinguish them from movable personal objects, or *chattels personal*. Today, it is more common to refer to a lessee's interest as an interest in, or right to, real estate.



Trade fixtures are personal property.

ducts). A trade fixture is to be removed by the tenant when the lease expires unless this right has been surrendered in the lease.

To decide whether an item is a trade fixture, and therefore personal property, or part of the real estate, courts use the following criteria.

1. The manner in which the item is affixed. Generally, an item is considered personal property if it can be removed without serious injury to the real estate or to itself. There are exceptions to this rule.
2. The character of the item and its adaptation to the real estate. Items that are specifically constructed for use in a particular building or installed to carry out the purpose for which the building was erected are generally considered permanent parts of the building.
3. The intention of the party who attached the item. Frequently, the terms of the lease reveal whether the item is permanent or to be removed at some future time.⁸

Appraisers must know whether an item is personal property or a fixture to decide if it will be included in the property value indication. If an item is classified as a fixture, and therefore part of the real estate, its contribution to value is included in the value estimate. It may not be possible, however, to exclude personal property from a value estimate. Because the distinction between fixtures and personal property is not always obvious, appraisers should know how courts in their jurisdictions define these items. Personal property that is related to real estate and is to be included in an appraisal should be identified and described in the appraisal.

8. Kratovil and Werner, 18-23.

APPRAISAL PRACTICE

In our complex society, professional real estate appraisers perform a variety of functions and services. They estimate several types of defined value and may advise clients and participate in decisions about real estate.

Appraisers perform analyses and render opinions or conclusions relating to the nature, quality, value, or utility of specified interests in, or aspects of, identified real estate. *Appraisal is defined as the act or process of estimating value.*⁹ Real estate appraisal involves selective research into appropriate market areas; the assemblage of pertinent data; the use of appropriate analytical techniques; and the application of knowledge, experience, and professional judgment to develop an appropriate solution to an appraisal problem.

The nature of the real estate problem indicates whether the task is an appraisal (valuation) or a consulting assignment (analysis or evaluation). The value estimated may be market value, insurable value, investment value, or some other properly defined value of an identified interest or interests in a specific parcel or parcels of real estate as of a given date. Valuation assignments may produce market value estimates of fee simple estates, leasehold estates, preservation easements, and many other interests. *Consulting is the act or process of providing information, analysis of real estate data, and recommendations or conclusions on diversified problems in real estate other than estimating value.*¹⁰ Consulting assignments include land utilization studies, supply and demand studies, economic feasibility studies, highest and best use analyses, and marketability or investment considerations that relate to proposed or existing developments.

In an appraisal assignment, the appraiser provides the client with an estimate of real property value which reflects all pertinent market evidence. In a consulting assignment, current market activity and evidence are studied to form a conclusion which may not lead to a specific value indication. In both types of assignments, conclusions are derived from appropriate data analysis performed in conformance with accepted standards of professional practice.

The application of appraisal procedures and the report that communicates the appraiser's conclusions are guided by the nature of the assignment. To avoid misunderstandings, it is important that the client and the appraiser determine whether the assignment is an appraisal or a consulting assignment.

A third type of assignment that appraisers perform is *appraisal review*, which refers to *the act or procedure of critically studying a report prepared by another appraiser.*¹¹

PURPOSE AND USE OF AN APPRAISAL

*The purpose of an appraisal is the stated reason for an appraisal assignment, i.e., to estimate a defined value of any real property interest, or to conduct an evaluation study pertaining to real property decisions.*¹² The purpose of an appraisal is established by the client. It points to the information that the client needs to an-

9. The Appraisal Foundation, *Uniform Standards of Professional Appraisal Practice* "Definitions" and Appraisal Institute, *Supplemental Standards of Professional Appraisal Practice* "Definitions Problems."

10. Ibid.

11. Ibid.

12. Specific definitions of the terms *appraisal* and *appraisal assignment* are cited in the Code of Professional Ethics and Standards of Professional Appraisal Practice of the Appraisal Institute. Members and affiliates of the Appraisal Institute should be familiar with these definitions.