

# Valuation Overview of Accessory Dwelling Units

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# AIM HIGHER

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# Our History

The Appraisal Institute was established when the American Institute of Real Estate Appraisers (AIREA) and the Society of Real Estate Appraisers (Society) unified in January 1991. AIREA and the Society, founded in 1932 and 1935, respectively, were created to help standardize the appraisal process by promoting professional education and upholding high ethical standards.

**1932**

AIREA is formed as an affiliate of the National Association of Realtors. *The Appraisal Journal* is launched. The Metro New Jersey Chapter becomes the first chartered chapter.

**1945**

The MAI designation program is introduced (AIREA's MAI designation dates back to the 1930s)

**1961**

The Society opens a Washington, DC, office to establish a voice among the leaders of Congress and the federal government.

**1981**

*The Appraisal of Real Estate* is translated and published in German. 14 additional international editions have been published since then.

**1989**

Congress passes the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which establishes state appraisal certification/licensing for federally related transactions.

**1992**

The Y. T. and Louise Lee Lum Library is established.

**2000**

The Appraisal Institute introduces *Appraiser News Online* (ANO).

**2014**

The Appraisal Institute begins issuing two review designations: the AI-GRS and AI-RRS.

**1935**

The U.S. Building and Loan League sponsors the Society, which establishes appraisal guidelines and standards. After completing education and experience requirements, the first SRA designation is conferred.

**1951**

The first edition of *The Appraisal of Real Estate* is published.

**1969**

The Society initiates the Young Advisory Council (YAC), a series of roundtable discussions on topics of interest to appraisers and analysts, now known as LDAC.

**1987**

AIREA and the Society are founding sponsors of The Appraisal Foundation, which is established to work with the government to create a self-regulatory system.

**1991**

AIREA and the Society formally merge into the Appraisal Institute.

**1996**

The first quarterly issue of *Valuation Insights & Perspectives* (now *Valuation*) is introduced.

**2003**

The first MAI designations are conferred upon Korean appraisers.

With more than 85 years of history, the Appraisal Institute continues to serve as the nation's largest professional organization of real estate appraisers. Through its designation programs, educational offerings, advocacy efforts and publishing endeavors, the Appraisal Institute maintains its leadership position within the real estate industry and continues to be a leader in the global valuation profession.



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# Acknowledgments

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## **SOLUTIONS**



# Overview

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## Seminar Description

This seminar provides an overview of the valuation of accessory dwelling units (ADUs) and would be of value to any appraiser involved in residential valuation where accessory dwelling units are part of the growing trend to meet housing needs in a market. The primary emphasis is on the description, legal concerns, valuation methods, and techniques needed to value ADUs.

Many markets are reporting a housing shortage in all price ranges but particularly in the affordable housing sector. To combat specifically affordable housing needs, more municipalities are updating their zoning to legally and relatively easily allow single-unit housing to add one or more ADUs.

From 1957 until late 2020, accessory dwelling units were forbidden in Chicago. 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 known as North, Northwest, West, South, and Southeast. Within these districts, it includes all R zones, except RS-1.<sup>1</sup> These areas are part of a pilot project. The referenced website in the footnote provides a downloadable FAQ on the ordinance.

In a growing number of states with urban metropolitan centers, the market has excessive demand for housing. This demand drives the price of homes higher, pushing out more affordable housing options. Examples of such markets include San Francisco, California; Portland, Oregon; and Seattle, Washington. These states and others like Minnesota and Michigan have all adopted zoning changes to provide relief to the housing affordability challenge and combat the rising cost of housing. These markets and others will be highlighted in this seminar.

Some may argue that ADUs will not provide large numbers of housing units for low or very low income families. Most agree that there is no one solution to affordable housing. However, combined with other options, ADUs are and still continue to be a part of the solution. The Pros: ADUs can be permitted and developed faster than large multiunit apartments. The cons: ADUs can only provide one unit at a time. Nonetheless, the growing construction of such units provides appraisers with an opportunity to add this type of business to their practice when they acquire the knowledge to understand what constitutes an ADU, appropriate methods for valuing ADUs, and solutions to dilemmas that can occur.

The following is an overview of the seminar content. Part 1 provides a review of the definitions and various names used around the country to describe ADUs. It dives into why this living unit is playing an important part in meeting the shortage of housing and sets the stage for identifying the markets where ADUs might be very popular and the most likely buyer of an ADU.

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1. <https://blog.chicagocityscape.com/chicagos-adu-ordinance-explained-in-a-4-minute-video-62c765c45640>

Part 2 focuses on zoning restrictions and ordinances that materially affect ADUs and how they are valued. Such zoning ordinances may affect the income-producing capability of an ADU and thus the highest and best use. ADUs were not addressed in many local ordinances in the early 2000s, but changes are taking place to allow such options in residential neighborhoods or communities.

Part 3 addresses the various secondary mortgage market appraisal guidelines and government agency appraisal guidelines that set the basis for lending on this asset/collateral type. Emphasis throughout this part and in the overall seminar is on the importance of recognizing and valuing the highest and best use accurately for properties with ADUs.

Part 4 is an overview of the complexity of data to adequately value ADUs. Multiple Listing Services (MLSs) often do not have searchable data fields to find sales or listings with ADUs. The market is not consistent in the names applied to ADUs, further complicating the data search. Assessor's records often do not have ADUs identified, which eliminates these records as a potential resource.

Part 5 gives an overview of the approaches to value followed by a variety of real-life ADU dilemmas, allowing the class to put into practice the valuation methods and concerns covered in the previous four parts.

## Learning Enhancements

The seminar has been designed with a variety of elements to enhance your learning experience.

- **Preview.** To give you a taste of what is to come, each part begins with a *Preview* page, which includes a brief overview of the content, learning objectives to consider as you move through the content, and, where appropriate, learning tips that will assist you in understanding the material you're about to cover.
- **Learning Objectives.** Each learning objective covers information required for understanding the concepts in the seminar. Look them over before the part begins so that you have a frame of reference as you move through the material. At the end of each part, reread the objectives. Are you able to do what is stated? If not, this is the time to ask your instructor for help or review the concepts that you do not understand.
- **Examples and Problems.** Supplementing the discussions, we've included examples and problems to provide everyday illustrations and help you visualize and practice what you are learning.
- **Discussion Questions.** To foster further discussion, we have included discussion questions that may or may not have a definitive correct answer, but they will elicit opinions.

- **Dilemmas.** To supplement the discussions, we've included dilemmas of varying length and complexity to help you apply what you are learning.
- **Review.** Each part concludes with a *Review* page, which repeats the learning objectives and lists key terms and concepts that have been covered. Also, where applicable, we've provided recommended readings from textbooks, which will reinforce what you have learned in class.
- **Solutions.** A tabbed section of suggested solutions appears at the end of the seminar Handbook. This section contains solutions to the discussion questions, problems, and dilemmas. Working through the problems and dilemmas before looking at the suggested solutions helps you determine if you understand the concepts or if you need to ask additional questions.

## USPAP References in this Seminar

All references in this seminar to the Uniform Standards of Professional Appraisal Practice (USPAP) are taken from the 2020–2021 edition (Washington, D.C.: The Appraisal Foundation).

## Classroom Guidelines

To make the seminar a positive experience for everyone attending, we have some guidelines for your consideration:

- 100% attendance is required. No exceptions.
- Limit use of computers and wireless devices to classroom projects.
- Communicate with business associates during break time instead of class time.
- Put away reading materials such as newspapers and books that are not used in class.
- Please silence cell phones and other communication devices.
- Please do not record the lectures. Recordings are not permitted.
- Refrain from ongoing conversations with those seated near you and other distracting behavior.

## Learning Objectives

After completing this seminar, participants will be better able to:

- Define and describe an accessory dwelling unit (ADU).

- Understand the role ADUs play in the housing market.
- Identify reasons ADUs are commonly added to an existing improvement.
- Recognize characteristics of the most common buyers and renters of ADUs.
- Apply the appropriate highest and best use analysis for ADUs as improved properties.
- Identify the zoning criteria that may limit ADUs.
- Understand secondary mortgage market appraisal guidelines and government appraisal guidelines and requirements.
- List data challenges that complicate the assignment.
- Solve short ADU dilemmas using valuation methods.

## General Information

- **Calculator.** None required.
- **Breaks.** There will be regular breaks scheduled during the seminar unless noted otherwise by the course sponsor. The lunch break is one hour.
- **Attendance sheets** will be distributed during class to verify your attendance during the entire seminar.
- **Certificates of completion** may be downloaded after completion of the seminar.
- **Attendance during the entire seminar** is required.

## Recommended Textbooks

*The Appraisal of Real Estate*, 15th ed. Chicago: Appraisal Institute, 2020.

*The Dictionary of Real Estate Appraisal*, 7th ed. Chicago: Appraisal Institute, 2022.

*Scope of Work*, Third Edition, Chicago: Appraisal Institute, 2020.



# Seminar Schedule

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## SECTION 1

<b>Overview</b>
Registration and sign-in
<b>Introduction</b>
Orientation and classroom rules Seminar Description Introduction
<b>Part 1: Definitions and Descriptions of an Accessory Dwelling Unit</b>
Review of the Definitions and Characteristics of an Accessory Dwelling Unit, Other Names for ADUs Role of ADUs in the Housing Market Causes of the Housing Shortage and Places It Occurs Pros and Cons of Attached Versus Detached ADUs Characteristics of an Ideal Lot or an Improved Property for an ADU Reasons for Resistance to an ADU Profiles for an ADU: Buyer and Renter Profiles Highest and Best Use Morning Break
<b>Part 2. Identifying the Master Plan and Zoning Criteria That Affect ADUs</b>
Why Is the Master Plan and Zoning a Deciding Factor for ADU valuation? 2.1 Discussion Question 2.2 Problem: Is This an ADU? Appraiser Certification Concerns 2.3 Problem

## SECTION 2

### Part 3. Secondary Mortgage Market Appraisal Guidelines and Government Agency Appraisal Requirements and ADUs

Fannie Mae: Secondary Mortgage Market Appraisal Guidelines and ADUs

Fannie Mae Selling Guidelines and ADUs: Part B

Morning Break

Fannie Mae Zoning for an ADU. Standards Rules, Glossary  
3.2 Dilemma, 3.3 Dilemma, 3.4 Dilemma

Freddie Mac: Secondary Mortgage Market Appraisal Guidelines and ADUs.

Accessory Unit FAQs

U.S. Department of Housing and Urban Development, FHA  
Single Family Housing Policy Handbook 4000.1

Lunch

## **SECTION 2, cont.**

### **Part 3. Secondary Mortgage Market Appraisal Guidelines and Government Agency Appraisal Requirements and ADUs, cont.**

Veterans Administration: Secondary Mortgage Market Appraisal Guidelines and ADUs  
Comparison of Secondary Mortgage Market Guidelines and Government Agency Appraisal Requirements  
3.8 Exercise, 3.9 Exercise, 3.10 Dilemma  
Review of 1004 Appraiser Certification

### **Part 4. Data Challenges That Complicate the Assignment**

Multiple Listing Service (MLS) Data Challenges  
4.1 Dilemma  
Public Property Records  
Other Real Estate Platforms – Zillow.com & Realtor.com  
Afternoon Break

### **Part 5. Solving ADU Valuation Dilemmas**

Sales Comparison Approach  
Income Capitalization Approach  
Cost Approach  
Dilemmas: 5.6 Dilemma – 5.9 Dilemma  
Afternoon Break  
Dilemmas: 5.10 Dilemma – 5.18 Dilemma  
Wrap-up, final questions





## Section 1

# 1

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**Part 1. Definitions and Descriptions of an Accessory Dwelling Unit**

**Part 2. Identifying the Master Plan and Zoning Criteria That Affect ADUs**



# Introduction

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This seminar provides resources and discusses methodology and valuation challenges appraisers face in valuing accessory dwelling units (ADUs). 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.<sup>2</sup> Currently, ADUs are a growing trend in large metropolitan cities across the nation as previously discussed in the overview of this seminar. Recent changes in the secondary mortgage market selling guidelines provide more guidance and flexibility in valuing and financing the units. Prior to the 2020 Fannie Mae Selling Guide update, it was next to impossible for appraisers to meet the agency appraisal guidelines because three sales of “comparable” ADU properties were nonexistent in some markets.<sup>3</sup> Many 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.

Financing was not the only barrier: local land use, zoning ordinances, and planning control by local governments presented barriers for ADUs. These barriers resulted in ADUs being added illegally. When not properly permitted, the public property record does not identify ADUs, and often MLSs do not code them, complicating the search for comparable sales.

Part 3 of this material will address the selling guidelines of Fannie Mae, Freddie Mac, Veterans Administration, Housing and Urban Development – Federal Housing Administration ((HUD-FHA), and the United States Department of Agriculture (USDA) as they apply to appraisal assignments.

ADUs play an important part in the housing market’s response to not only the shortage of housing but also the affordability of the housing unit. Society and individuals can benefit from ADUs. More municipalities promote the use of infill development because it makes efficient and “green” use of existing infrastructure. ADUs are well-designed and offer positive benefits to infill development by increasing densities to levels that make transportation more viable with lower costs and quicker permitting processes than for larger, multifamily building types. Because ADUs tend to be relatively small and their amenities modest, they provide more affordable housing options (at less than one-third of the cost of comparable units in multifamily buildings). Oftentimes, these living units are the only rental housing available in older, predominantly single-unit neighborhoods, making it possible for people from diverse backgrounds to live in the area. This seminar provides education to meet the challenge these properties present and could help to

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2. <https://neimanarchitects.blogspot.com/2016/09/upcoming-policy-changes-to-backyard.html#:~:text=history%20Accessory%20dwelling%20units%20can%20be%20traced%20back,satisfy%20changing%20family%20needs%20and%20provide%20rental%20income>
  3. Fannie Mae Selling Guidelines are covered in Part 3.

prevent a negative situation like the one mentioned below, which occurred in Minneapolis.

Appraisers beware ...

Changes in state and local zoning regulations are taking place around the country to address affordable housing and looming shortages in more densely populated areas. These changes in laws are having tremendous impacts on the highest and best use of properties in these neighborhoods. Appraisers need to be aware of and understand the implications these zoning changes can have on the valuation process so they ensure competent completion of appraisal assignments in these markets.

### Example

On June 1, 2020, the Minnesota Department of Commerce (the regulatory body for appraiser licensing and enforcement in Minnesota) sent a reminder Notice of New Zoning Laws to appraisers and appraisal management companies. These laws went into effect in Minneapolis on January 1, 2020. Since the enactment, the Minnesota Department of Commerce has reviewed 135 appraisal reports of Minneapolis properties and found the following results:

- Only 117 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
- Zero had data in the workfile to support the highest and best use analysis or conclusion (The real problem was the failure to summarize the analysis in the Appraisal Report.)

Appraisers can avoid these pitfalls by getting the training needed to understand the compliance necessary to complete these types of assignments competently. *Valuation Overview of Accessory Dwelling Units* addresses three areas that are important in the valuation of ADUs and all properties:

- Specific zoning classification and description
- Highest and best use analysis
- Appraisal Report documentation versus workfile support

## **Definitions and Descriptions of an Accessory Dwelling Unit**

Appraisers are encountering appraisal assignments with a variety of accessory dwelling units. Until the last three years, zoning ordinances and agency appraisal guidelines and requirements contained little discussion of accessory dwelling units (ADUs), and in fact, some forbade them. Property owners seeking a permit to add an ADU were often greeted with the “not in my backyard” (NIMBY) attitude. Times are changing, and the demand for social change and affordable housing is giving property owners reasons to find ways to assist family members or supplement their income by adding ADUs. Some additional reasons for adding ADUs include an aging population needing home care, lack of retirement income in the elderly population, climate factors, concern for expanding housing into farmland that can be used for food for future generations, immigrant families who prefer multigenerational living, and college graduates unable to afford housing due to college debt. Agency appraisal guidelines and requirements are also changing; appraisers are facing limited data and inexperience in determining value for properties with ADUs. Part 1 will start with the basics of defining an ADU, listing market names that differ for ADUs, and emphasizing the importance of training in today’s challenging real estate landscape.

### **Learning Objectives**

To prepare for Part 1, read the following learning objectives and refer back to them as you study this part of the handbook.

- Define an accessory dwelling unit (ADU).
- Identify other names given to ADUs.
- Recognize the importance of ADUs in today’s market.
- Identify characteristics of an ideal lot for an ADU.

### **Learning Tips**

Accessory dwelling units are often referenced with different names in various U.S. markets. Understanding terms used in your market will take a little research of the MLS and zoning ordinances along with discussion with market participants such as other real estate professionals. The handbook provides a long list of names found in various markets. Now is a good time to make notes that may apply to your market and write down resources that other participants share.





# Part 1.

## Definitions and Descriptions of an Accessory Dwelling Unit

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### I. Review of the Definitions and Characteristics of an Accessory Dwelling Unit

#### A. Definitions and descriptions

**Accessory dwelling unit.** *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.*<sup>4</sup>

“An ADU is typically an additional living area independent of the primary dwelling that may have been added to, created within, or detached from 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.”<sup>5</sup>

“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.”<sup>6</sup>

“An additional living area that includes at least a kitchen, a bathroom, and a separate entrance and is independent from the primary dwelling unit.”<sup>7</sup>

“An ADU refers to a habitable living unit added to, created within, or detached from a primary one-unit, Single Family dwelling, which together constitute a single interest in real estate. It is a separate additional living unit, including kitchen, sleeping, and bathroom facilities.”<sup>8</sup>

**Note.** United States Department of Agriculture (USDA) does not define ADU.

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4. Unless otherwise noted, all definitions in italics are taken from *The Dictionary of Real Estate Appraisal*, 7<sup>th</sup> ed. Chicago: Appraisal Institute, 2022.
  5. Fannie Mae 09/2020 Accessory Unit Selling Guide Updates, Section B2-3-04, Special Eligibility Considerations.
  6. Veterans Administration Lender Handbook, VA Pamphlet 26-7, Chapter 11, P. 11-10, [www.benefits.va.gov](http://www.benefits.va.gov).
  7. <https://guide.freddiemac.com/app/guide/section/5601.12>.
  8. Housing and Urban Administration (HUD/FHA) Glossary dated 11/18/2020, [https://www.hud.gov/program\\_offices/administration/hudclips/handbooks/hsgl](https://www.hud.gov/program_offices/administration/hudclips/handbooks/hsgl).

## B. Predominant ADU characteristics in definitions

While the ADU definitions are worded differently, the repeated attributes are as follows:

1. Kitchen
2. Bath
3. Sleeping area
4. Separate entrance
5. Shares a site with a single-unit structure

C. These ADU definitions may vary in your local zoning ordinances. It is the appraiser's responsibility to address not only the agency's appraisal guidelines or requirements but also the zoning as it applies to the space. When these 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.

**Note.** Ryan Taylor, an architect in Atlanta, GA,<sup>9</sup> warns that a guesthouse is not always an ADU. If the guesthouse is merely a couple of bedrooms and maybe a bath but does not have a kitchen, it is not an ADU. Keep the five attributes above in mind to determine if the unit is a guesthouse or an ADU.

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9. Ryan Taylor, architect at Ryan Taylor Architects, LLC, conducted a spring series in 2020 focused on accessory dwelling units. <https://www.gotostage.com/channel/ryantaylorarch>.

D. Other names for accessory dwelling units

1. Accessory apartment
2. Accessory dwelling
3. Accessory dwelling unit
4. Accessory suite (Usually references an attached ADU)
5. Accessory unit
6. ADU
7. Ancillary unit
8. Backyard cottage
9. Basement apartment
10. Carriage house
11. Casita (Arizona)
12. Coach house
13. Dawdy house (among Amish)
14. Garden cottage (detached ADU)
15. Garden suite (used in Canada)
16. Grand retreat
17. Granny cottage
18. Granny flat
19. Granny pod
20. Granny unit
21. Guest unit
22. Home within a Home® (by Lennar marketing<sup>10</sup>)
23. In-law suite
24. In-law unit
25. “JADU” or “junior accessory dwelling unit” — a small, internal ADU
26. Laneway house (West coast of Canada)
27. Mother-in-law flat
28. Mother-daughter house
29. Multigenerational homes
30. Next Gen (a commercial name by Lennar)
31. Ohana unit (in Hawaii)
32. SDU (Secondary or single-dwelling unit)
33. Second unit
34. Secondary dwelling unit
35. Secondary suite (more common name in Canada)
36. Secondary unit
37. Sidekick (BrightBuilt Homes from Portland, ME)
38. Tiny house (May be an ADU)
39. Two-family house

The list reflects the most common names for ADUs in today’s market; however, appraisers must realize that for lending purposes, the term is *accessory dwelling unit (ADU)*, and that is the term used in this material. The lack of consistency in names presents challenges for appraisers to identify comparable properties in public record or MLS searches. The challenges and possible solutions are addressed in Part 5.

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10. <https://www.lennar.com/ProductsAndServices/NextGen#Explore%20Next%20Gen%20Living>.

## II. Role of ADUs in the Housing Market

Trends in the market are typically a result of needs that are not being met such as societal changes or governmental changes and regulations. Understanding the needs that brought about a change in real estate, lending, and zoning and the popularity of ADUs today must be recognized. Part of the analysis is the appraiser's understanding of this property feature and how to value its worth in a market. Below are some reasons the real estate market, agency appraisal guidelines and requirements, and zoning jurisdictions are reacting to new housing ideas and the growing presence of ADUs.

- A. The growing trend toward ADUs is an outcome of the 2020-2021 housing shortage and affordability challenges the market faces nationwide. In the past, ADUs existed but were not always welcome in residential neighborhoods or even allowed by zoning. However, that did not stop homeowners from adding on an ADU or building an ADU. These units were typically built out of the need to house a family member and provide privacy for the homeowner and the family member(s). In most cases the nonconforming use was often overlooked by zoning officials and neighborhoods unless the occupants or structure became a distraction, or the issue became known at the time of sale. Later in this seminar, we will address the issues surrounding financing of the nonconforming units.
- B. In the past four years, the real estate market has experienced a growing demand for homeownership as the economy improved. Because of the loss experienced during the housing crisis in the 2008-2010 period, builders are not as willing to risk building speculative houses. New construction has not met the demand for housing. The existing housing inventory is low in most markets, and that spurs the increase in sale prices (a simple demand/supply trajectory). The pandemic caused many potential sellers to stay longer in their homes, adding to the inventory shortage. Some markets have less than three months of inventory where the normal inventory once was around six months.

## 1.1 Example

A good example of the price increase in the last year and prediction for 2021 is taken from the REALTOR® Magazine showing Y-O-Y percentage change in the median sale price for existing single-family and condo/coop homes in the U.S.

- 2019 – +4.9%
- 2020 – +7.8% estimated as of November 2020
- 2021 – +4.5% forecasted<sup>11</sup>

The REALTOR® article indicates the renters transitioning to homeownership are faced with sticker shock at the increasing prices of homes. Even with record low mortgage rates, housing affordability is slipping away from first time homebuyers and renters. Adding to the affordability crisis is the Covid-19 pandemic, which left potential homebuyers facing employment issues. Lastly, many college attendees are finding affordability challenges a major issue for renting or buying because of college debt.

C. A combination of the housing shortage and the rising cost of buying or renting single-family houses has added to the affordability challenges. As a result of these challenges, there has been a renewed interest in ADUs, which may provide additional income and present fewer restrictions.

1. One of the pros for adding an ADU or purchasing a home with an ADU is that the rental income will assist the buyer in qualifying for the loan and purchase price. Although many zoning ordinances allow an ADU to be rented, the buyer must recognize that rental income from an ADU cannot be considered in qualifying a buyer for a Fannie Mae or Freddie Mac loan.<sup>12</sup> However, institutions offering alternative loan products or not selling to the secondary mortgage market will commonly consider the rental income in qualifying the buyer.
2. Another pro for adding ADUs in one-unit housing neighborhoods is the ability to construct them in a timely manner and with fewer restrictions than building the primary dwelling structure on the subject property's site. Properties with sufficient lot sizes to accommodate these smaller units are ideal for adding an ADU as long as they meet setback and other zoning requirements.

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11. Lawrence Yun, "Real Estate in 2021: Plenty of Reasons for Optimism," *REALTOR® Magazine* (Chicago: National Association of REALTORS, January 2021).

12. Fannie Mae 09/2020 Accessory Unit Selling Guide Updates, Section B2-3-04, Special Eligibility Considerations.

3. Proponents of ADUs suggest that the addition of ADUs will not change the character of a residential neighborhood. Historical homes often had a carriage house over a garage or servant quarters added without negative consequences to values.

## 1.2 Example

**Washington D.C.** has a number of old alley apartments; many of these date back to the 1700s. These alley apartments met a housing need at the time and still do. Many have been removed, most likely due to condition and quality of construction; according to the *Intelligencer*, reported in 1865, many were made of cut-rate lumber and covered with tar or felt. Approximately 20 alleys with alley apartments still exist.<sup>13</sup>

**Chicago, IL.** As mentioned in the Course Overview, Chicago forbade ADUs from 1957 until December 16, 2020. Due to the housing shortage and affordability concerns, the city council passed an ADU ordinance that allows ADUs in 5 districts known as North, Northwest, West, South, and Southeast; within those, it includes all R zones, except RS-1.<sup>14</sup> These areas are part of a pilot project. The footnote references a website that provides a downloadable FAQ on the ordinance.

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

- D. 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 services that impact the environment and cost of housing. ADUs can be designed to blend in with the surrounding architecture and maintain the primary structure's compatibility with established neighborhoods and preserve community character.

13. <https://www.hillrag.com/2018/03/08/capitol-hill-alley-dwellings/>.

14. <https://blog.chicagocityscape.com/chicagos-adu-ordinance-explained-in-a-4-minute-video-62c765c45640>.

### III. Causes of the Housing Shortage and Places It Occurs

Overall housing inventory plummeted 43% in January 2021, compared to the same month in 2020. New listings were also down by 23% year over year. The home shortage increased U.S. median home prices by 15.4%, up to a national average of \$346,000. The market is so tight across the country that the typical home spent 76 days on the market in January 2020, or 10 days less than in 2019.<sup>15</sup>

- A. Rising lumber costs and lack of supply threaten consumers' housing options. Housing affordability has been a critical issue across the country for years, and factors such as local, regional, national, and even global crises make things worse as housing prices continue to soar, and builders face challenges to meet ongoing housing demands.

“The continuing rise in building costs – including rising lumber prices, availability of material, tools, equipment, parts, etc. – is causing a sudden downturn in new home starts,” said Cory Lord, a builder based in Georgia. “We are finding it hard to complete current contracts on time, and homeowners are not able to afford to sign new contracts with the escalated costs.”<sup>16</sup>

- B. Beyond just local and state governments, the federal government, specifically the U.S. Department of Housing and Urban Development, publishes biennially the Worst Case Housing Needs report to the U.S. Congress. This seminar will discuss the report and how it also supports the need for ADUs as rental units to combat affordable housing needs and the high cost of housing. The Department is working closely with its federal, state, local, and tribal partners to reduce regulatory barriers to housing construction and development and to facilitate a range of affordable rental and sustainable homeownership options.<sup>17</sup>

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15. <https://www.realtor.com/research/january-2021-data/>.

16. <https://nahbnow.com/2021/02/rising-lumber-prices-and-lack-of-supply-threaten-consumers-housing-options/>.

17. <https://www.huduser.gov/PORTAL/publications/worst-case-housing-needs-2020.html>.

## 1.3 Exhibit

**Very Low-Income Renters Experienced Worst Case Needs Across Every Region and Metropolitan Location in 2017**

Region	Metropolitan Location				Total
	Central Cities	Suburbs, Urban	Suburbs, Rural	Nonmetropolitan Areas	
<b>Northeast (thousands)</b>	<b>2,165</b>	<b>1,346</b>	<b>182</b>	<b>268</b>	<b>3,961</b>
Percentage with worst case needs	36.5	41.6	44.1	35.6	38.5
Percentage with housing assistance	39.6	29.6	27.0	28.9	34.8
<b>Midwest (thousands)</b>	<b>1,665</b>	<b>963</b>	<b>272</b>	<b>769</b>	<b>3,670</b>
Percentage with worst case needs	35.5	43.0	43.3	33.1	37.5
Percentage with housing assistance	33.6	25.4	26.7	32.3	30.7
<b>South (thousands)</b>	<b>2,873</b>	<b>1,771</b>	<b>650</b>	<b>1,064</b>	<b>6,358</b>
Percentage with worst case needs	44.8	53.1	44.2	30.9	44.7
Percentage with housing assistance	26.1	17.9	22.6	35.7	25.1
<b>West (thousands)</b>	<b>2,292</b>	<b>1,207</b>	<b>255</b>	<b>324</b>	<b>4,078</b>
Percentage with worst case needs	50.0	46.2	49.2	42.6	48.3
Percentage with housing assistance	26.9	27.1	18.9	31.8	26.9
<b>Total (thousands)</b>	<b>8,995</b>	<b>5,287</b>	<b>1,360</b>	<b>2,425</b>	<b>18,067</b>
Percentage with worst case needs	42.4	46.8	44.9	33.7	42.7
Percentage with housing assistance	30.9	24.4	23.3	33.1	28.7

Source: HUD-PD&R tabulations of American Housing Survey data

The 1.3 Exhibit shows the distribution of the nation's 18.07 million very low-income renter households across the four census regions and four metropolitan categories. On a regional basis, the very low-income renter households are listed below and on the next page.

- 6.36 million—live in the South
- 4.08 million live in the West
- 3.96 million live in the Northeast
- 3.67 million live in the Midwest (2017)

Central cities are home to most (9.00 million) very low-income renter households, followed by suburbs (6.65 million) and nonmetropolitan areas (2.43 million).<sup>18</sup>

18. Nicole Elsasser Watson, Barry L. Steffen, Marge Martin, David A. Vandenbroucke, "Worst Case Housing Needs 2019 Report to Congress" (Washington, D.C., U.S. Department of Housing and Urban Development, June 2020), P. 14-15.



**Comment.** Housing shortages and rising new construction costs are putting pressure on the market to find alternatives. For many people, an ADU provides a partial solution to the housing affordability and shortage solution for a portion of the population trying to find housing. However, it is equally recognized that ADUs are not the long-term sustainable solution to the housing challenge. Nonetheless, this housing option is gaining traction throughout the U.S.

To have a compliant and credible appraisal report, the report must discuss the following:

- Causes of the housing shortage and what is happening in markets where this rising improvement product is part of the inventory for new home construction and existing homes
- Activity in the sale and rental markets

This discussion should occur throughout the appraisal report; for example, discussion should be found in the Neighborhood/Market description, the subject Site/Highest and Best Use as well as the improvements discussion, and the approaches to value associated with the research, analysis, and explanation of the data gathered and used to determine applicable opinions and conclusions throughout the appraisal report and the final value opinion.

#### IV. Pros and Cons of Attached Versus Detached ADUs

Prior to designing an ADU it is important to determine the ideal improvement for the site considering its surroundings. The following table presents some pros and cons for an attached ADU versus a detached ADU.

<b>1.4 Table. Attached ADUs Versus Detached ADUs</b>		
<b>Features Pros and Cons</b>	<b>Detached ADUs</b>	<b>Attached ADUs</b>
May provide rental income	X	X
Space already exists, reduces construction costs		X
Less impact on scale or character of neighborhood, often goes unnoticed		X
Does not impact open space property		X
Can be directly connected to the primary house (family member convenience)		X
Faster return on investment		X
Soundproofing efforts more difficult to accomplish with attached walls		X
Superior privacy	X	
Clear boundaries between primary house & ADU	X	
Higher potential to impact neighbors' privacy and open space	X	

##### A. Internal or interior ADU

These two terms are used to describe an ADU where a portion of an existing home – entire floor, part of a floor, or an attic or basement – is partitioned off and renovated to become a separate residence.<sup>19</sup>

19. <https://www.aarp.org/content/dam/aarp/livable-communities/livable-documents/documents-2019/ADU-guide-web-singles-071619.pdf>.

## B. Characteristics of an ideal lot or an improved property for an ADU

One of the highest and best use tests is to determine physical possibility as vacant and as improved. The following characteristics are traits that might suggest the property is suitable to add an ADU, or it might assist in identifying potential obsolescence in an existing ADU property.

1. Proper zoning. Refer to the zoning ordinance because many ordinances only allow ADUs in residentially zoned areas. Due to the changes to the International Residential Code (IRC),<sup>20</sup> which today includes codes for ADUs for residential housing, more states and in turn, municipalities began to change their zoning to include density requirements to allow ADUs in zones that once did not allow them.
2. Neighborhoods with premium pricing. A prospective renter probably could not afford to rent a house in the neighborhood, but an ADU makes it affordable.
3. Detached garage. The concept of using the space or building above a garage is not new. However, in many jurisdictions this now qualifies as an ADU. If the garage structure has a second story, it will cost less to convert it into living space than a one-story that may require structural changes to the garage before adding a second story living space.
4. Deep lot. A deep lot provides more distance between the primary house and ADU for privacy and may even offer separate parking. Keep in mind that most ordinances have setback requirements that would apply to an ADU. Further, other more specific code requirements may be required for ADU approval, including lot coverage minimum, on-site stormwater, etc., which might affect the ADU buildable size or even omit the approval of an ADU.
5. Wide driveway or extra-large parking space. Narrow driveways that require tandem parking become an inconvenience for occupants of the primary improvement and the ADU. Some zoning ordinances have parking requirements for each living unit. Also, it could materially affect the rental income.
6. Alley access. Alleys, for example, can provide convenient access to detached garage ADUs or ADUs built in larger yards as a result of the alley access.
7. Location close to public transportation and services (shopping or employment hubs). If public transportation is near, the ADU becomes more attractive to a student or person who does not own a car and needs public transportation to school or work. Another benefit is that some jurisdictions do not have parking requirements if public transportation is proximate.

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20. International Residential Code – <https://codes.iccsafe.org>.

8. Public water and sewer. Adding an ADU to a lot with a well and/or septic could present additional costs or affect the ability to obtain an ADU permit.

#### C. Reasons for resistance to ADUs

1. Size. In predominantly older, existing residential areas attractive to residential households, the improvement sizes tend to be on the smaller side. Portland, Oregon is an example. The size of an ADU is limited because it cannot exceed 30% of the existing home's living area.

For example, a 1940s home that is 900 square feet limits the ADU size to 270 square feet (900 × 30%).

2. Strangers nearby. Additional resisters include having a stranger live in one's backyard. The potential income may not be worth the concern for one's family and other occupants in the primary residence.
3. Misconceptions. For example, some property owners thought an ADU could be used as an Airbnb<sup>21</sup> to generate income. Instead, such use was illegal under zoning requirements in their area. Even when it is legal, the owners may not realize the additional expenses of qualifying as an Airbnb such as the payment of a "hotel tax" and hotel business license.<sup>22</sup>

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21. Airbnb is a franchise name, and most are considered short-term rentals despite the Bed and Breakfast (BnB) reference in the franchise name.

22. <https://thinkrealty.com/the-promise-and-pitfalls-of-accessory-dwelling-units-as-an-affordable-housing-panacea/>.



**What is an Airbnb? The phrase stands for air bed and breakfast. The concept was born in 2007 when Joe Gebbia and Brian Chesky were living in San Francisco and saw hotels booked when conferences came to town. They decided to rent floor space in their lounge room. They purchased 3 air beds and advertised on their website, “Air bed and breakfast for rent.”**

**Source:** <https://www.chegg.com/homework-help/questions-and-answers/read-following-extract-answer-questions-follow-20-marks-joe-gebbia-brian-chesky-sharing-lo-q54861138>

**Airbnb is a booking platform for a residential property that hosts short-term rental space to travelers. The space can be anything from an entire house to a bedroom, boat, tree house, or accessory building.**

**Joe Gebbia, Nathan Blecharczyk, and Brian Chesky are noted as the cofounders of Airbnb.** <https://www.thedailybeast.com/Airbnb-founders-brian-chesky-nathan-blecharczyk-and-joe-gebbia-check-in-for-dollar55-billion-ipo-payday>

**Note:** Vrbo® is a vacation rental platform where homeowners can rent their homes without going through a property management company. Again, a property with an ADU renting through this platform is a short-term rental in the same category as an Airbnb. In some markets, a resistance to ADUs is based on the following:

- Parking requirements
- Overcrowding fears
- Loss of residential neighborhood character
- Negative impact on existing and future property values

## V. Profiles for an ADU

### A. Buyer profile

In concluding the highest and best use test of the maximally productive use, consider the potential buyer profile for a residential property with an ADU that may include the following:

1. Buyer with aging parents
2. Buyer with adult children unable to afford rental or home purchase
3. Buyer needing additional income\*
4. ....
5. ....
6. ....
7. ....
8. ....

Can you add to this list?

**\*Note.** Buyer or property owner requiring a mortgage that is sold to Fannie Mae or Freddie Mac would not be able to use the additional ADU income to qualify for the loan. Part 2 has a more in-depth review of the GSEs appraisal guidelines.

## B. Renter profile

If concluding the highest and best use test of the maximally productive use suggests the ADU will be for a renter, identify the renter profile for an ADU.

1. Student
2. Short-term rental
3. ....
4. ....
5. ....
6. ....
7. ....

Can you add to this list?

## VI. Highest and Best Use

Agency appraisal guidelines and requirements and interviews of lenders and review appraisers repeatedly report the importance of market analysis and highest and best use in valuing properties with ADUs. Below is an excerpt from the USDA Handbook 3550 emphasizing the USDA expectation of the highest and best use analysis and inclusion in the site analysis section.

- **“Accessory Dwelling Unit.** The presence of an accessory dwelling unit (ADU) does not automatically render the property ineligible. The appraiser will determine if the ADU represents a second single family housing dwelling unit. The Agency defers to the appraiser’s professional review of the property and expert opinion of the highest and best use of the subject property as a primary residence. The appraiser will include their evaluation in the site analysis section of the appraisal report if applicable.”<sup>23</sup>

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23. United States Department of Agriculture (USDA) Handbook 3555, Advanced Copy of Chapter 12, P. 12-4, [www.rd.usda.gov/files/3555-1chapter12.pdf](http://www.rd.usda.gov/files/3555-1chapter12.pdf).

At the end of Parts 1-4, you may add topics covered in the four tests of highest and best use as an example of items that should be analyzed in these appraisal assignments.

## 1.5 Discussion Question

Identify the material we covered that applies to the highest and best use.



Consider the material covered so far. In order for the appraisal to be compliant and credible, list the topics that should be covered in the four highest and best use tests as improved for an appraisal of an ADU property. (Keep adding to the list as we move through the material.)

1. Legally permissible

Zoning district and land use – what is legally permitted?

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2. Physically possible

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3. Financially feasible

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## 1.5 Discussion Question, cont.

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### 4. Maximally productive

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## Learning Objectives

Now that you've completed Part 1, you should be able to

- Define an accessory dwelling unit (ADU).
- Identify other names given to ADUs.
- Recognize the importance of ADUs in today's market.
- Identify characteristics of an ideal lot for ADUs.

## Terms and Concepts to Remember

Accessory dwelling unit (ADU)	ADU – attached	ADU and highest and best use
	ADU – detached	ADU and ideal improvement
Accessory unit		

## Recommended Resources

*Accessory Dwelling Unit Handbook*, California Department of Housing and Community Development, September 2020.

*Accessory Dwelling Unit Handbook*, California Department of Housing and Community Development, effective 2021.

<https://www.hcd.ca.gov/policy-research/accessorydwellingunits.shtml#booklet>

*Accessory Dwelling Units*, American Planning Association  
<https://www.planning.org/knowledgebase/accessorydwellings/>

*All about Accessory Dwelling Units*, American Association of Retired Persons (AARP)  
<https://www.aarp.org/livable-communities/housing/info-2019/accessory-dwelling-units-adus.html>

International Residential Code (IRC)  
<https://codes.iccsafe.org>

<https://codes.iccsafe.org/content/IRC2018P4>



## **Identifying the Master Plan and Zoning Criteria That Affect ADUs**

One of the crucial steps in the highest and best use is identifying what is legally permissible as vacant and as improved. The Introduction of this seminar noted the Minneapolis change in zoning and the notification that was addressed to appraisers and appraisal management companies. Other zoning jurisdictions have also amended the zoning laws that affect the use and legal status of existing units and allow for greater flexibility of adding new accessory units in residential areas. It is important to understand the zoning in the areas that you serve. Zoning compliance can affect the use, income potential, insurance, and underwriting guidelines for the secondary mortgage market.

### **Learning Objectives**

To prepare for Part 2, read the following learning objectives and refer back to them as you study this part.

- Identify zoning that may affect financing and valuation.
- Understand appraiser certification concerns.

### **Learning Tips**

Master plans and zoning are not uniform and are always the first place to start the valuation research because these involve an essential test of the highest and best use, i.e., its legal permissibility. In other words, what can legally be done with the property as vacant and as improved? The agency appraisal guidelines and requirements reviewed in developing this seminar identified recent updating regarding ADU policies that are legal, legal nonconforming, illegal, and those constructed without building permits. Interviews of appraisal management companies, appraisers, real estate agents, and secondary mortgage market policymakers provided valuable information, which was incorporated in this seminar.



# Part 2.

## Identifying the Master Plan and Zoning Criteria That Affect ADUs

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### I. Why is the Master Plan and Zoning a Deciding Factor for ADU Valuation?

- A. One of the critical steps in determining the highest and best use is knowing what is legally permissible. That brings us to the discussion of the jurisdiction's master plan and zoning designation for ADUs and determining what is legally allowed where ADUs are permissible.

When investigating what is legally permissible, an appraiser should look at the master plan for the subject property's jurisdiction to understand how the community responds to and plans to deal with residential properties and ADUs. The following items should be researched:

- Do changes over time increase the capacity to add such units to existing or new construction markets?
  - What is the time frame for anticipated changes?
  - Has the topic of ADUs been discussed at the government level, i.e., Board of Supervisors, county elected officers?
  - What is the tenor for such housing changes – favorable, not favorable, neutral?
- B. This type of information is part of the neighborhood description of trends, the site section when discussing zoning description of trends, and the approaches to value, specifically the tenor of the elected officials toward this housing option.
1. Lenders need to know if this is a common improvement addition in other homes in the subject property's market. Also, what is the political attitude about going forward with this housing product type based on the master plan and other zoning data collected?
  2. A misconception by some residential appraisers is that simply stating the zoning or paraphrasing the zoning and not including a description of the zoning is acceptable.
    - a. 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.

- b. The actual zoning designation and description for the subject property, meaning the zoning classification and details of that zoning must be researched and analyzed to determine if the appraisal property is legal, legal conforming, legal nonconforming, illegal, or those constructed without building permits in the subject property's jurisdiction. If the property is legal nonconforming, it was legal at one point, and the zoning requirements changed. Now it is "grandfathered in." It is legal.
- c. In many jurisdictions, zoning is accessible online, making it easier to research and document your appraisal report and workfile. If it is not accessible online, an appraiser needs to determine how to obtain this information; for example, purchasing the ordinance data or making a trip or call to the building/zoning department in charge of the subject property's site data. In other words, this data must be verified with a primary data source to ensure accurate information is reported versus simply using the zoning reference in public records or the MLS system.



### **Caution:**

Zoning may not and likely will *not* define an ADU in the same manner as the secondary mortgage market, both being important to the lender. In the appraisal report, it is necessary to identify and describe the applicable zoning for the ADU based on the zoning ordinance; explain the analysis applied to determine the subject property's highest and best use conclusion, which includes whether or not the subject property meets the zoning ordinance; and finally, describe how the completed data collected, verified, and analyzed applies to the lender's guidelines or requirements based on your 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 if and how the subject property complies (or does not comply) with the subject property's zoning, how the highest and best use conclusion is supported, and thereafter, how to proceed with the underwriting requirements of the loan.



## 2.1 Discussion Question

When the secondary mortgage market does not acknowledge the space as an ADU, but the zoning ordinance does allow the ADU space as improved, how should an appraiser proceed without being misleading?



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## 2.2 Problem



### Zoning: Is This an ADU?

Read through the description below and the zoning excerpts on the next two pages. Then answer the questions that follow.

A house is offered for sale and described as follows: Move-in ready, updated primary house plus additional living quarters on over a 0.5-acre corner lot in a subdivision zoned RSF 5, Residential Single Family, allowing 5 units per acre. Separate utilities and new central air were installed in 2019. The primary residence features 3 bedrooms, 3 baths, living room, and family room. The additional living unit has 2 bedrooms, 1 bathroom, and an open living area. Both residences are updated with a freshly painted interior and exterior, neutral décor, new tile flooring throughout, remodeled kitchen with raised panel cabinetry, solid surface counters, and tile backsplash plus baths with new tile, vanities, and lighting. The additional living unit includes a patio area for outdoor entertaining. The property has a circular driveway with space to park an RV plus room for a pool. The property has a private well and septic.



The aerial was taken from the County GIS Mapping.

## 2.2 Problem, cont.

### **Residential Single-Family 5 Units Per Acre (RSF 5) Zoning Excerpts**

*Permitted accessory uses and structures:* Uses and structures that are customarily accessory and clearly incidental to permitted uses and structures, including approved conditional or special exception uses, are permitted in this district, including, but not limited to:

Accessory structures, including, but not limited to, garages, carports, and sheds.

1. Detached accessory structures greater than two hundred fifty (250) square feet but no greater than four hundred (400) square feet in area. All roofs must be pitched and include overhangs and eaves which meet current building codes. Rounded corners are prohibited. These structures are allowed with metal siding in the same color as the primary structure. If an exact color match is not possible, a complementary and non-contrasting color may be allowed.
2. Detached accessory structures greater than four hundred (400) square feet but no greater than one thousand five hundred (1,500) square feet in area allowed with wall or leg heights no more than twelve (12) feet tall as measured from the point of installation (grade level). Any increase in wall or leg height greater than twelve (12) feet may be allowed with an increase of required setbacks (all sides) of five (5) feet for every one (1) foot of height increase. All roofs must be pitched and include overhangs and eaves that meet current building codes.
3. Detached accessory structures greater than one thousand five hundred (1,500) square feet must be site built and constructed of the same materials as the primary structure. Any increase in wall or leg height greater than twelve (12) feet may be allowed with an increase of required setbacks (all sides) of five (5) feet for every one (1) foot of height increase. All roofs must be pitched and include overhangs and eaves that meet current building codes. Rounded corners are prohibited. Colors must match those of the primary structure.
4. The total area of all detached accessory structures shall not exceed ten (10) percent of the parcel size or one thousand (1,000) square feet, whichever is greater, for a property less than one-half acre in size. If the property is one-half ( $\frac{1}{2}$ ) acre or more in size, the total area of all detached accessory structures shall not exceed three thousand (3,000) square feet.
5. Detached accessory structures shall be located behind the leading edge of the living area of the residence except garages and carports, which must still maintain required setbacks.

## 2.2 Problem, cont.

6. Conditional uses and structures (C): (For rules and regulations for any use designated as conditional uses and structures.)
7. 1) Bed and breakfast, one (1) or two (2) bedrooms.
8. 2) Guest home.
  - a. Provided the lot area shall not be less than twice the minimum lot area required for a single-family dwelling.
  - b. Must be under one (1) ownership.
  - c. Must comply with all development standards within the appropriate zoning district.
  - d. Must be built of the same materials and in the same color scheme as the principal dwelling.
  - e. Impact fee<sup>24</sup> shall be assessed as a dwelling unit.

*After reviewing the description, aerial view of the property, and zoning excerpts, what questions might you have to determine if the subject property includes an ADU? Using the data presented, answer the following questions.*

1. *Based on this information, are there any issues present that might either positively or negatively influence the market value of the property?*
2. *Is there other information you believe is necessary to identify the 2-bedroom, 1-bath improvement as an ADU?*
3. *Does the subject property meet the zoning ordinance requirements?*
4. *Does the subject property meet secondary mortgage market appraisal guidelines for lending purposes?*

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24. Impact fees. A one-time fee imposed by local governments on the property developer. The fee is to offset the financial impact of new development on public infrastructure, roads, schools, utilities, and other services.

## 2.2 Problem, cont.

5. *How would you address these questions in the highest and best use analysis?*

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## 2.2 Problem, cont.

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6. *In the appraisal of this property, should the impact fees be included? Explain.*

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## II. Appraiser Certification Concerns

It's important to review the Appraiser Certification for the agencies' appraisal report forms (e.g., URAR) and also identify concerns that require additional discussion to avoid certifying to something that is not true. The Appraiser Certification is not designed to protect the appraiser, and it is sometimes the place where appraisers commit errors of omission by certifying to something they did *not* do.

Appraisers doing litigation work or appraisers facing complaints at their state appraiser board report that the Appraiser Certification is where weaknesses or appraisal errors in reports are often identified.

**Note.** Agency appraisal report forms are to be used for lending purposes only. The agency appraisal forms are *not* suitable for litigation work.

Take a few minutes to review the Appraiser Certification and then respond to the corresponding discussion questions.

## Uniform Residential Appraisal Report

File No.

**APPRAISER'S CERTIFICATION:** The Appraiser certifies and agrees that:

1. I have, at a minimum, developed and reported this appraisal in accordance with the scope of work requirements stated in this appraisal report.
2. I performed a complete visual inspection of the interior and exterior areas of the subject property. I reported the condition of the improvements in factual, specific terms. I identified and reported the physical deficiencies that could affect the livability, soundness, or structural integrity of the property.
3. I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.
4. 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.
5. I researched, verified, analyzed, and reported on any current agreement for sale for the subject property, any offering for sale of the subject property in the twelve months prior to the effective date of this appraisal, and the prior sales of the subject property for a minimum of three years prior to the effective date of this appraisal, unless otherwise indicated in this report.
6. I researched, verified, analyzed, and reported on the prior sales of the comparable sales for a minimum of one year prior to the date of sale of the comparable sale, unless otherwise indicated in this report.
7. I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.
8. I have not used comparable sales that were the result of combining a land sale with the contract purchase price of a home that has been built or will be built on the land.
9. I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales.



## Uniform Residential Appraisal Report, cont.

File No.

**APPRAISER'S CERTIFICATION:** The Appraiser certifies and agrees that:

10. I verified, from a disinterested source, all information in this report that was provided by parties who have a financial interest in the sale or financing of the subject property.
11. I have knowledge and experience in appraising this type of property in this market area.
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.
13. I obtained the information, estimates, and opinions furnished by other parties and expressed in this appraisal report from reliable sources that I believe to be true and correct.
14. I have taken into consideration the factors that have an impact on value with respect to the subject neighborhood, subject property, and the proximity of the subject property to adverse influences in the development of my opinion of market value. I have noted in this appraisal report any adverse conditions (such as, but not limited to, needed repairs, deterioration, the presence of hazardous wastes, toxic substances, adverse environmental conditions, etc.) observed during the inspection of the subject property or that I became aware of during the research involved in performing this appraisal. I have considered these adverse conditions in my analysis of the property value, and have reported on the effect of the conditions on the value and marketability of the subject property.
15. I have not knowingly withheld any significant information from this appraisal report and, to the best of my knowledge, all statements and information in this appraisal report are true and correct.
16. I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions, which are subject only to the assumptions and limiting conditions in this appraisal report.
17. I have no present or prospective interest in the property that is the subject of this report, and I have no present or prospective personal interest or bias with respect to the participants in the transaction. I did not base, either partially or completely, my analysis and/or opinion of market value in this appraisal report on the race, color, religion, sex, age, marital status, handicap, familial status, or national origin of either the prospective owners or occupants of the subject property or of the present owners or occupants of the properties in the vicinity of the subject property or on any other basis prohibited by law.

## Uniform Residential Appraisal Report, cont.

File No.

**APPRAISER'S CERTIFICATION:** The Appraiser certifies and agrees that:

18. My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application).
19. I personally prepared all conclusions and opinions about the real estate that were set forth in this appraisal report. If I relied on significant real property appraisal assistance from any individual or individuals in the performance of this appraisal or the preparation of this appraisal report, I have named such individual(s) and disclosed the specific tasks performed in this appraisal report. I certify that any individual so named is qualified to perform the tasks. I have not authorized anyone to make a change to any item in this appraisal report; therefore, any change made to this appraisal is unauthorized and I will take no responsibility for it.
20. I identified the lender/client in this appraisal report who is the individual, organization, or agent for the organization that ordered and will receive this appraisal report.
21. The lender/client may disclose or distribute this appraisal report to: the borrower; another lender at the request of the borrower; the mortgagee or its successors and assigns; mortgage insurers; government sponsored enterprises; other secondary market participants; data collection or reporting services; professional appraisal organizations; any department, agency, or instrumentality of the United States; and any state, the District of Columbia, or other jurisdictions; without having to obtain the appraiser's or supervisory appraiser's (if applicable) consent. Such consent must be obtained before this appraisal report may be disclosed or distributed to any other party (including, but not limited to, the public through advertising, public relations, news, sales, or other media).
22. I am aware that any disclosure or distribution of this appraisal report by me or the lender/client may be subject to certain laws and regulations. Further, I am also subject to the provisions of the Uniform Standards of Professional Appraisal Practice that pertain to disclosure or distribution by me.

## Uniform Residential Appraisal Report, cont.

File No.

**APPRAISER'S CERTIFICATION:** The Appraiser certifies and agrees that:

23. The borrower, another lender at the request of the borrower, the mortgagee or its successors and assigns, mortgage insurers, government sponsored enterprises, and other secondary market participants may rely on this appraisal report as part of any mortgage finance transaction that involves any one or more of these parties.
24. If this appraisal report was transmitted as an "electronic record" containing my "electronic signature," as those terms are defined in applicable federal and/or state laws (excluding audio and video recordings), or a facsimile transmission of this appraisal report containing a copy or representation of my signature, the appraisal report shall be as effective, enforceable, and valid as if a paper version of this appraisal report were delivered containing my original hand written signature.
25. Any intentional or negligent misrepresentation(s) contained in this appraisal report may result in civil liability and/or criminal penalties including, but not limited to fine or imprisonment or both under the provisions of Title 18, United States Code, Section 1001, et seq., or similar state laws,

Freddie Mac Form 70 March 2005

Fannie Mae Form 1004 March 2005

## 2.3 Problem



Review the 1004 Appraiser Certification and identify the items that require attention in the appraisal.

1. **Certification 4:** 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.

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2. **Certification 7:** I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.

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## 2.3 Problem, cont.

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3. **Certification 11:** I have knowledge and experience in appraising this type of property in this market area.

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### 2.3 Problem, cont.

4. *Does taking a seminar on ADUs result in an appraiser being competent to complete these types of appraisal assignments? Explain.*

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## Learning Objectives

Now that you've completed Part 2, you should be able to

- Identify zoning that may affect financing and valuation.
- Describe appraiser certification concerns.

## Terms and Concepts to Remember

Certification

Highest and best use as  
vacant

Master plan

Guesthouse

Impact fees

Zoning

Highest and best use as  
improved

## Recommended Resources

Below are a book and Appraisal Institute courses that cover writing skills, developing adjustments, and developing a supported highest and best use.

*Residential Report Writing and Case Studies*

*Advanced Residential Applications and Case Studies/Part I*

*Residential Market Analysis and Highest & Best Use*

*Residential Property Appraisal* by Mark R. Ratterman, MAI, SRA





## Section 2

# 2

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**Part 3. Secondary Mortgage Market Appraisal Guidelines  
and Government Agency Appraisal Requirements  
and ADUs**

**Part 4. Data Challenges That Complicate the Assignment**

**Part 5. Solving ADU Valuation Dilemmas**



## Secondary Mortgage Market Appraisal Guidelines and Government Agency Appraisal Requirements and ADUs

The secondary mortgage market appraisal guidelines must be considered if the appraisal assignment is for a lender underwriting the loan through the secondary mortgage market. While Fannie Mae, Freddie Mac, Housing and Urban Development (HUD-FHA), and Veterans Administration (VA) differ on some topics, an appraiser must review the appraisal guidelines or requirements in developing the appraisal that apply to the assignment. This will ensure compliance with the agencies' scope of work and methodologies.

### Learning Objectives

To prepare for Part 3, read the following learning objectives and refer back to them as you study this part of the handbook.

- Identify financing guidelines that affect valuation.
- Recognize USPAP standards that apply.
- Understand the data limitations.

### Learning Tips

The secondary mortgage market appraisal guidelines and government agency appraisal requirements address ADUs. Being aware of these appraisal guidelines and requirements is important to understanding the limitations that may complicate the appraisal assignment and require discussion with the client *before* completion.



# Part 3.

## Secondary Mortgage Market Appraisal Guidelines and Government Agency Appraisal Requirements and ADUs

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### I. Fannie Mae: Secondary Mortgage Market Appraisal Guidelines and ADUs

- A. The following guidelines are taken from the Fannie Mae Selling Guide dated 09/02/2020, B4-1.3-05. The entire Selling Guide can be downloaded from the Fannie Mae website.<sup>25</sup>

**Part B, Origination Through Closing**  
**Subpart B2, Eligibility**  
**Chapter B2-3, Property Eligibility**  
**Pages 256-258**

“Fannie Mae purchases or securitizes first-lien mortgages that are secured by residential properties when the dwelling consists of one to four units. Under some circumstances, Fannie Mae limits the number of dwelling units for certain types of mortgages or transactions. For the maximum allowable LTV, CLTV, and HCLTV<sup>26</sup> ratios and credit score requirements based on the property type and number of units, see the *Eligibility Matrix*.<sup>27</sup>”

**NOTE:** A one-unit property with an accessory dwelling unit (ADU) is defined as a one-unit property and subject to all one-unit requirements, unless otherwise stated. See B2-3-04, Special Property Eligibility Considerations (09/02/2020) for additional information on ADUs.”

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25. <https://selling-guide.fanniemae.com/>

26. LTV = Loan-to-Value; CLTV = Combined-Loan-to-Value; HCLTV = Home-Equity-Combined-Loan-to-Value

27. [https://www.fanniemae.com/content/eligibility\\_information/eligibility-matrix.pdf](https://www.fanniemae.com/content/eligibility_information/eligibility-matrix.pdf)

## B. Property requirements

The mortgaged premises must be

- Residential in nature as defined by the characteristics of the property and surrounding market area (see B4-1.3-03, Neighborhood Section of the Appraisal Report (06/03/2020));
- Secured by an interest in real property within the meaning of the Internal Revenue Code as such term is defined in 26 C.F.R. § 1.856-3;
- Safe, sound, and structurally secure (see B4-1.3-06, Property Condition and Quality of Construction of the Improvements (04/15/2014));
- Adequately insured per Fannie Mae guidelines for property and flood insurance (see B7-3, Property and Flood Insurance);
- The highest and best use of the property as improved (or as proposed per plans and specifications), and the use of the property must be legal or legal non-conforming use (see B4-1.3-04, Site Section of the Appraisal Report (06/05/2018));



### Accessory Dwelling Units

Updated 2020

“An accessory dwelling unit (ADU) is an additional living area that is independent of the primary property and has basic bathroom, cooking, and sleeping facilities. With this update, we clarified ADU property eligibility and comparable sales requirements in the appraisal as follows:

- Expanded the current definition of an ADU to improve proper classification of ADUs;
- Expanded property eligibility by allowing multi-width manufactured homes titled as real property to be eligible as an ADU; and
- Allow appraisal flexibilities that now include the use of
  - An aged settled sale to demonstrate market acceptability, and
  - An active listing, or a pending sale as a supplemental exhibit to show marketability.

**Effective:** Lenders may take advantage of these updates immediately.” (Fannie Mae update SEL-2020-05)

**Note.** Denis A. DeSaix, MAI, SRA, confirmed with Fannie Mae's Collateral Risk Department that the listings and pendings do **NOT** have to be comparable to the subject property since their purpose is to support the appraiser's opinion of the market's acceptance of ADUs. This is not the case if the specific subject's ADU is accepted by the market. These sales must not be in the sales comparison grid if they are not comparable (See Certification 7). However, they must be identified and discussed in the appraisal report for the intended user(s) to understand their relevancy.

- Readily accessible by roads that meet local standards (see B4-1.3-04, Site Section of the Appraisal Report);
- Served by utilities that meet community standards (see B4-1.3-04, Site Section of the Appraisal Report); and
- Suitable for year-round use

**Note:** Certain aspects of the location of a property will require special consideration. For example, properties in resort areas that attract people for seasonal or vacation use are acceptable only if they are suitable for year-round use.

#### C. Acceptable forms of property ownership

Title to the property must be held as fee simple, leasehold estate, or as a co-op form of ownership. (See B2-3-03, Special Property Eligibility and Underwriting Considerations: Leasehold Estates (08/07/2019); and B4-2.3-04, Loan Eligibility for Co-op Share Loans (08/07/2019), for additional information.)

#### D. Comparable sale requirements from Fannie Mae update SEL-2020-05

The 2020 updates mentioned under property requirements on the previous page give flexibility to the comparable sale requirements. No comparable sale with an ADU is required in the sales comparison approach (according to Fannie Mae), but it is advisable to include one (dated comparable sales are acceptable). To support ADU market acceptance, additional exhibits may include listings and pending sales with ADUs.

#### E. Acceptable dwelling types

Dwelling units for security properties may be detached, attached, or semi-detached.

Properties may be located

- On an individual lot,
- In a condo project,



- In a co-op project, or
- In a planned unit development (PUD) or subdivision project

Properties located in a condo, co-op, or PUD project must meet Fannie Mae's project standards requirements (see Chapter B4–2, Project Standards).

### **? Question: ADUs Used as Short-Term Rentals**

**Are ADUs used as short-term rentals acceptable dwelling types? (Airbnb and Vrbo are two platforms for advertising short-term rentals.)**

**Section Part B**, Origination Through Closing Subpart B2, Eligibility Chapter B2-3, “Property Eligibility of the Fannie Mae Selling Guide indicates that ineligible properties include boarding houses and bed and breakfast properties. Most Airbnb or Vrbo® properties are typically considered short-term rental properties despite the “BnB” reference in the name. With that in mind, those properties within Airbnb or Vrbo® that are not operating as a business such as a traditional Bed and Breakfast (which includes breakfast and/or other concierge type of services) would be eligible for delivery to Fannie Mae. The key differentiator is the operation of a business enterprise through meal service and/or other concierge type of services that would categorize a property as either a traditional Bed and Breakfast or a boarding house.”

**Source:** Interview on 2/18/2021, with Fannie Mae Single Family Collateral Risk representative. See later discussion on additional research when the ADU is used as a short-term rental through platforms like Airbnb or Vrbo®.

#### F. Ineligible properties

Fannie Mae does not purchase or securitize mortgages on

- Boarding houses
- Bed and breakfast properties
- Properties with two accessory dwelling units

**Note:** ADUs identified as one of the above properties would not be eligible for Fannie Mae purchase or securitized mortgages. In some areas, ADUs are used as bed and breakfast units. A search of the internet for bed and breakfasts units in the area may reveal the appraisal property is being advertised as such.

1. Lenders and/or appraisal management companies may order an appraisal on a property that is ineligible for sale to Fannie Mae. The appraiser may initially

accept the assignment and not discover the ineligibility until after the fact, for example, in discussion with the owner, at the time of or after the inspection.

2. Conversely, the ineligibility may be discovered before making the inspection during the property and market research stage; for example, through a search of the MLS, public record, aerial imagery or by simply searching the internet for the address of the property. If the property is advertised as a “bed and breakfast,” the appraiser should address the findings with the client before proceeding. **Note.** Be sure to document all communication with the client, and where possible put such communication in writing. Maintain all such communication in your workfile.

## Fannie Mae Selling Guidelines and ADUs

Part B, Origination Through Closing

Subpart B2, Eligibility

Chapter B2-3, Property Eligibility

09/02/2020

✓	Requirements
	<ul style="list-style-type: none"> <li>▪ The ADU must               <ul style="list-style-type: none"> <li>— be subordinate in size to the primary dwelling.</li> <li>— have the following separate features from the primary dwelling:                   <ul style="list-style-type: none"> <li>▪ means of ingress/egress,</li> <li>▪ kitchen,</li> <li>▪ sleeping area,</li> <li>▪ bathing area, and</li> <li>▪ bathroom facilities.</li> </ul> </li> </ul> </li> <li>▪ The ADU may, but is not required to, include access to the primary dwelling. However, it is not considered an ADU if it can only be accessed through the primary dwelling or the area is open to the primary dwelling with no expectation of privacy.</li> </ul>
	<ul style="list-style-type: none"> <li>▪ The kitchen must, at a minimum, contain the following:               <ul style="list-style-type: none"> <li>— cabinets;</li> <li>— a countertop;</li> <li>— a sink with running water; and</li> <li>— a stove or stove hookup (hotplates, microwaves, or toaster ovens are not acceptable stove substitutes).</li> </ul> </li> <li>▪ An independent second kitchen by itself does not constitute an ADU.</li> <li>▪ The removal of a stove does not change the ADU classification.</li> </ul>
	<p>A borrower must qualify for the mortgage without considering any rental income from the ADU. (See <a href="#">B3-3.1-08, Rental Income (06/03/2020)</a> for further information, and <a href="#">B5-6-03, HomeReady Mortgage Underwriting Methods and Requirements (07/03/2019)</a> for an exception for HomeReady mortgage loans.)</p>

## G. Construction of an ADU

The construction method of an ADU can be site – or factory-built. If factory-built, all designs must be multi-width and the primary dwelling must be site-built. If the ADU is manufactured housing, the lender must verify the following:

- The property was built in compliance with the Federal Manufactured Home Construction and Safety Standards (established June 15, 1976, as amended and in force at the time the home was manufactured),
- It is attached to a permanent foundation system in accordance with the manufacturer’s requirements for anchoring, support, stability, and maintenance,
- The foundation system must be appropriate for the soil conditions for the site and meet local and state codes,
- It is encumbered by the mortgage with the primary dwelling, and
- Additional requirements that appear in HUD regulations in 24 C.F.R. Part 3280.

Compliance with these standards will be evidenced by photos of either the HUD Data Plate or HUD Certification Label (or both) in the appraisal report. If the original or alternative documentation cannot be obtained for either the Data Plate/Compliance Certificate or HUD Certification Label, the loan is not eligible for delivery to Fannie Mae. See B2-3-02, Special Property Eligibility and Underwriting Considerations: Factory-Built Housing (12/04/2018), for more information.

## H. Examples of ADUs

Examples of ADUs include, (but are not limited to):

- A living area over a garage,
- A living area in a basement,
- A small addition to the primary dwelling, or
- A manufactured home (if it is real property).

“Whether a property is defined as a one-unit property with an accessory unit or a two- to four-unit property will be based on the characteristics of the property, which may include, but are not limited to, the existence of separate utility meter(s), a unique postal address, and whether the unit can be legally rented. The appraiser must determine compliance with this definition as part of the analysis in the Highest and Best Use section of the appraisal.” See B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020) for additional ADU appraisal requirements.

I. Fannie Mae: Zoning for an ADU [Where ADU is not allowed under zoning, update as of 9/2/2020]

Some ADUs may predate the adoption of the local zoning ordinance and therefore be classified as legal nonconforming. An ADU should always be considered legal if it is allowed under the current zoning code for the subject property.

“If it is determined that the property contains an ADU that is not allowed under zoning (where an ADU is not allowed under any circumstances), the property is eligible under the following additional conditions:

- The lender confirms that the existence will not jeopardize any future property insurance claim that might need to be filed for the property.
- The illegal use conforms to the subject neighborhood and to the market.
- The property is appraised based on its current use.
- The appraisal report states that the improvements represent a use that does not comply with zoning (“illegal” use).
- The appraisal report demonstrates that the improvements are typical for the market through an analysis of at least two comparable sales with the same non-compliant zoning use. Aged settled sale(s) with the same non-compliant zoning use are acceptable if recent sales are not available. At a minimum, the appraisal report must include a total of three settled sales.”
- The appraisal requirements related to zoning for an ADU are met. See B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020).

**Note.** Remember, an ADU should always be considered legal if it is allowed under the current zoning code for the subject property, even if it is nonconforming. The lender confirms the existence of the ADU will not jeopardize any future property insurance.

J. Accessory dwelling units and gross living area

1. “An ADU is generally an additional living area independent of the primary dwelling that may have been added to, created within, or detached from the primary dwelling. The ADU must have basic requirements for living, sleeping, cooking, and bathroom facilities on the same parcel as the primary dwelling.” See B2-3-04, Special Property Eligibility Considerations (09/02/2020), for complete ADU eligibility requirements.

2. “When reporting the living area of an ADU, it should **NOT** be included with the Gross Living Area calculation of the primary dwelling. It should be reported and adjusted for on a separate line in the grid, unless the ADU is contained within or part of the primary dwelling with interior access and above grade. If a standalone structure does not meet the ADU minimum requirements, it should be treated as any other ancillary structure and included as a separate line item in the sales comparison approach [and] then adjusted based on its contributory value to the subject property.”<sup>28</sup>
3. “Whether a property is defined as a one-unit property with an ADU or a two-to four-unit property will be based on the characteristics of the property, which may include, but are not limited to, the existence of separate utility meter(s), a unique postal address, and whether the unit can be legally rented.

The appraiser must determine compliance with this definition as part of the analysis in the highest and best use section of the appraisal. When there is an ADU, the appraisal report must include a description of the ADU and analysis of any effect it has on the value or marketability of the subject property. The appraisal report must demonstrate that the improvements are acceptable for the market. An aged, settled sale will qualify as a comparable, and an active listing or under contract sale will qualify as a supplemental exhibit to show marketability.”

**Note.** Based on the Fannie Mae appraisal guidelines previously reviewed, it is not considered an ADU if it can only be accessed through the primary dwelling or the area is open to the primary dwelling with no expectation of privacy.

If the ADU has interior access through the primary dwelling unit and exterior access, there must be a way to close off the ADU from the primary dwelling unit.

**Source:** This information was confirmed with a Fannie Mae representative on April 2, 2021.

#### 4. Definitions

**Legal nonconforming use.** *A use that was lawfully established and maintained, but no longer conforms to the use regulations of its current zoning; sometimes known as a legally nonconforming use. (The Dictionary of Real Estate Appraisal, 7<sup>th</sup> ed.)*

In the bullet points under zoning on the previous page, Fannie Mae calls an illegal use “a use that does not comply with zoning.”

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28. Fannie Mae Selling Guide, B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020).



## Best Practice Tip

- Describe the research conducted.
- Explain the data collected.
- Explain the verification process of the data.
- List the relevant and specific opinions and conclusions.
- Clearly explain how an adjustment was developed. (Paired-data, cost less depreciation, regression analysis, income approach, survey of agents, etc.) Be sure any specifics or supporting data is summarized in the appraisal report to meet the intended use, and {be sure} only “other” data, information, and documentation the client does not need to understand how the adjustment was developed is in your workfile. (See USPAP SR 2-2(a)(viii) and (x) (5), see page 96 line 276 – all other data.)
  - New construction that includes an ADU but has not sold will qualify as market support of acceptance along with sales, listings, and pending properties with ADUs.
- The ADU description should be factual, relevant, and specific (providing photographs of each room and its exterior is highly recommended). Beyond the description, the appraisal report must also include an analysis of any effect the ADU has, positive, neutral, or negative, on the value or marketability of the subject. Include previous items listed above to produce a credible appraisal that includes a clear understanding of the property and the analysis that was completed.

### K. Resources for identifying the property

Let’s stop here and learn how to identify the one-unit property with an ADU versus a two- to four-unit property. The 3.1 Table, Identifying the Property Type, which follows this discussion, provides features to identify the relevant characteristics and property type and also provides considerations for the highest and best use. These are items addressed in STANDARDS Rule 1-2(e) (on the next page) and in Advisory Opinion 23, and partially addressed in the appraisal guidelines for Fannie Mae.

1. STANDARDS RULE 1-2(e)

**STANDARDS RULE 1-2, PROBLEM IDENTIFICATION**

“In developing a real property appraisal, an appraiser must:

(e) identify, from sources the appraiser reasonably believes to be reliable, the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including:

(i) its location and physical, legal, and economic characteristics;

(ii) the real property interest to be valued;

(iii) any personal property, trade fixtures, or intangible assets that are not real property but are included in the appraisal;

(iv) any known easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of a similar nature; and

(v) whether the subject property is a fractional interest, physical segment, or partial holding;

- **Comment on (i)–(v):** An appraiser may use any combination of a property inspection, documents, such as a legal description, address, map reference, copy of a survey or map, property sketch, photographs, or other information to identify the relevant characteristics of the subject property.”

**Source:** USPAP, STANDARDS RULE 1-2, PROBLEM IDENTIFICATION

2. STANDARDS RULE 1-3, Market Analysis, and Highest and Best Use, is inserted on the next page to continue the discussion of identifying a property correctly. Is it a one-unit property with an ADU versus a two- to four-unit property with no ADU? Incorrect identification is another area reported as a problem with some appraisers calling an ADU property a two-, three-, or four-unit property and incorrectly using the Small Residential Income (two- to four-unit) appraisal report form.



## STANDARDS RULE 1-3, MARKET ANALYSIS, AND HIGHEST AND BEST USE

“When necessary for credible assignment results in developing a market value opinion, an appraiser must:

- (a) identify and analyze the effect on use and value of:
  - (i) existing land use regulations;
  - (ii) reasonably probable modifications of such land use regulations;
  - (iii) economic supply and demand;
  - (iv) the physical adaptability of the real estate; and
  - (v) market area trends; and

**Comment:** An appraiser must avoid making an unsupported assumption or premise about market area trends, effective age, and remaining life.

- (b) develop an opinion of the highest and best use of the real estate.

**Comment:** An appraiser must analyze the relevant legal, physical, and economic factors to the extent necessary to support the appraiser’s highest and best use conclusion(s).” (USPAP, STANDARDS RULE 1-3)

### 3. Additional resource on the topic of relevant characteristics

Advisory Opinion 23, SUBJECT: *Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment* (USPAP, The Appraisal Foundation, 2020-2021)

- 4. After reviewing the relevant characteristics from the 3.1 Table (on the next page), an appraiser should be able to determine the relevant characteristics, real property type, applicable approaches to value, applicable appraisal report form, and also consider the highest and best use. As mentioned previously, these are identified in STANDARDS RULE 1-2(e) and partially in the Fannie Mae guidelines. Reviewing the Fannie Mae definition for a two- to four-unit property, which is provided on the next page, is also helpful.

## Glossary of Fannie Mae Terms – E-3-20 dated 2/06/2019

### Two– To Four-Unit Property

“A property that consists of a structure that provides living space (dwelling units) for two to four families, although ownership of the structure is evidenced by a single deed.”

**3.1 Table. Identifying the Property Type**

Features	One-Unit with ADU	Two- to Four-Unit
State current use		
Separate utility meter(s)		
Unique postal address		
Can be legally rented		
Zoning – Conforming or Nonconforming?		
Land use (any restrictions) See definition on next page.		
Is the ADU subordinate to the primary dwelling?		
Does the ADU contribute less value to the land than the primary dwelling?		
Does the ADU have an exterior entrance?		
Can the ADU be accessed only from the interior of the primary dwelling?		
Can the ADU be accessed from both the interior and exterior? (Interior must be closed off from primary dwelling unit for expectations of privacy.)		
What is the highest and best use?		
How are the subject or other similar properties listed in the MLS? Search expired, active, sold, and expired listings.		
How do buyers and sellers identify the property? Single-unit with an ADU or as a two- to four-unit property?		

**Land use.** 1. The employment of a site or holding to produce revenue or other benefits. 2. The designation by a governing authority of the use to which land may be put to promote the most advantageous development of the community, e.g., designation of industrial, residential, commercial, recreational, and other uses under a master plan.<sup>29</sup>

### 3.2 Dilemma



Can a residential state-licensed appraiser take an assignment that is a one- to four-unit property with an ADU that is now considered a five-unit property?

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29. *The Dictionary of Real Estate Appraisal*, 7<sup>th</sup> ed. Chicago: Appraisal Institute, 2022.

### 3.3 Dilemma



#### **Appraiser Experience with an ADU That Is Not Legal (Steps an Appraiser Could Take)**

The owner of the subject property advises the appraiser that the ADU is not legal; therefore, based on the following discussion, the appraiser decides to value the property in the following manner:

1. The appraiser will contact the client/intended user and advise them of the circumstances. **Note.** It is important that the client agrees with the approach being taken by the appraiser in completing the appraisal assignment.
2. If the intended user(s) is acceptable to moving forward with the appraisal assignment following the appraisal process discussed, the appraiser will check the master plan and current and anticipated zoning for the subject property.
3. Thereafter, the appraiser will speak with the zoning/code enforcement personnel to determine if the ADU could become legal and what that effort would entail. If the conclusion is that the subject property's ADU has a reasonable and plausible course of action to become legal under the current zoning, the appraiser will contact the intended user to discuss these findings.
4. Based on the appraisal assignment conditions and a discussion with the client, the appraiser is asked to value the property subject to a hypothetical condition. The condition will include the subject property being reclassified as a legal one-unit property with an ADU as of the effective date of the appraisal.
5. The appraisal report will summarize the support, including data collected, conversations with the zoning/code enforcement personnel, sources used in the value opinion conclusions, and research completed. To ensure the client can understand the appraisal, the appraiser will provide a summary in the appraisal report of the conversation with code/enforcement personnel regarding the current illegality of the subject property as well as the steps necessary for the subject property and the ADU to become legal. The workfile will contain all other data, information, and documentation collected but not necessary for the client to understand the appraisal report. *Is this the correct approach?*

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**3.3 Dilemma, cont.**



**Appraiser Experience with an ADU That Is Not Legal, cont.**

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### 3.3 Dilemma



#### **Appraiser Experience with an ADU That is Not Legal, cont.**

What if the code enforcement personnel are certain that an ADU is **not** permitted and that there is **no** path for the ADU to become legal? Based on that discussion, the appraiser asks what would need to be done to bring the subject property to a legal conforming status without the qualification of the additional structure as an ADU. Experience in the subject property's market tells the appraiser the most common solution is removal of the stove. Other times, it has been the removal of the entire kitchen.

The conclusions of the discussion with the code enforcement personnel need to be disclosed to the client, along with the approach to the appraisal assignment. No matter what the requirement is to bring the subject property to a legal conforming status, the appraisal report must provide a clear explanation of why the ADU cannot be made legal as well as the requirements that must be met to bring the subject property to a legal status without the additional structure qualifying as an ADU.

Based on the appraisal assignment conditions and a discussion with the client, the appraiser is asked to value the property "subject to" a hypothetical condition. The condition will include the subject property meeting all the code requirements for legal conforming status as of the effective date of the appraisal. In the appraisal report, the following must be disclosed and supported, the data collected, and research completed. Such research must include the conversation with code/enforcement personnel regarding the current status of the subject's ADU and the specific steps necessary to bring the subject property into legal conforming compliance. *Is this the correct approach?*

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## Fannie Mae Additions without Permits

“If the appraiser identifies an addition(s) that does not have the required permit, the appraiser must comment on the quality and appearance of the work and its impact, if any, on the market value of the subject property.”

**Source:** Fannie Mae – B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020)

### 3.4 Dilemma



**First scenario:** Assume an ADU cannot be made legal. The conversion of existing space to living area is located in the basement and includes both access from the exterior and through the primary dwelling (e.g., walkout basement with interior access)? *What are the most appropriate options to value the subject property?*

If the converted space is in the basement, then this area is included in the value only as finished basement space. This is true because an accessory unit is required to be *independent* of the primary unit (i.e., with an expectation of privacy). This means access to the accessory unit must **not** be possible by passing through the primary dwelling unit. With this scenario, the basement is not fully independent since access to the primary unit is not restricted.

**Second scenario:** The ADU cannot be made legal. The converted space or addition in the basement is above grade and again, one of the accesses to the space is through the primary dwelling. With the second scenario, this area *is* included in the GLA (for the same reason as noted in the first scenario).

**Third scenario:** Assume the ADU cannot be made legal. The converted space no longer has access or never had access from the interior of the primary dwelling (e.g., attached garage converted to living space with only an exterior access, detached garage with converted attic space to living area, detached free-standing improvement). For the third scenario, this area is **not** included in the GLA; it is valued as a non-GLA area or an ADU if it meets the ADU requirements of kitchen, bath, living, and sleeping facilities.

**Note.** If the appraiser simply pretends the illegal space does not exist, the appraisal is based on the hypothetical condition that the space does not exist when in fact it does.

### 3.4 Dilemma. cont.



#### Three Scenarios, cont.

*Is this the correct approach?*

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## II. Freddie Mac: Secondary Mortgage Market Appraisal Guidelines and ADUs

- A. “Freddie Mac will purchase an eligible Mortgage on a 1-unit property that has one accessory unit. An accessory unit 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. To be eligible, the accessory unit must be subordinate in living area and contribute less to the value of the property than the primary dwelling unit. Examples of eligible accessory unit configurations include a dwelling with a unit above a garage, a dwelling with an attached or detached unit or a dwelling with a unit in the basement.” (5601.12, Property Description and Analysis)



B. "A Mortgage may be eligible when the accessory unit is legal, legal non-conforming or illegal based on the unit's compliance with the zoning and land use requirements. The appraiser must identify whether the property is a 1-unit property with an accessory unit or a 2-unit property and report the appraisal on the appropriate report form. The primary factor that differentiates a 2-unit property from a 1-unit property with an accessory unit is the zoning and land use requirements. The appraiser must consider all property characteristics, specifically the unit's utility and the property's highest and best use, when making this determination. The appraisal report must include a description of the accessory unit and reflect any effect the accessory unit has on the market value or marketability of the subject property. A Mortgage secured by a 2- to 4-unit property with one or more accessory units is **NOT** eligible for purchase by Freddie Mac."<sup>30</sup>

1. List the ADU characteristics identified by this guideline.

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2. The primary factor that differentiates a 2-unit property from a 1-unit property with an accessory unit is the zoning and land use requirements.

C. Ineligible properties

1. "Freddie Mac does not purchase Mortgages secured by:

- Vacant land, undeveloped land or land development properties
- Properties used primarily for agriculture or farming
- Properties used primarily for commercial enterprises (including, but not limited to bed and breakfasts, boarding houses, Condominium Hotels and units located in PUDs operating as a hotel or similar type of transient housing that includes hotel type services and characteristics)" (5601.12, Property Description and Analysis)

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30. Quoted text on this page and the following page came from <https://guide.freddie.com/app/guide/section/5601.12>.

**Note:** The Freddie Mac guide does not address Airbnbs or Vrbos®. However, the above policy is not meant to exclude properties being rented through such platforms for short-term rentals. It's meant to exclude properties with hotel type amenities/characteristics (e.g. condotels, PUDs with rental agreements, etc.

**Source:** Interview with Freddie Mac Single Family Policy Director

D. Comparable requirements for properties with legal or legal nonconforming zoning compliance or locations without zoning

“If the subject property accessory unit complies with the zoning and land use requirements (legal or legal non-conforming or locations without zoning), the appraisal report must include:

- At least one comparable sale with an accessory unit, when available, to demonstrate the property's conformity and marketability to its market area. If a recent comparable sale with an accessory unit is not available in the subject neighborhood, the appraiser can use [analyze] an older sale with an accessory unit from the subject neighborhood or a sale with an accessory unit from a competing neighborhood as a comparable sale or as supporting market data. The appraiser may always use [analyze] more than three comparable sales, including contract sales (pending sales) and/or current listings, to justify and support his or her adjustments and opinion of market value, as long as at least three are actual closed (settled) sales. (5601.12, Property description and analysis)
- If a comparable sale with an accessory unit is not available, the appraiser can use [analyze] a comparable sale in the subject neighborhood without an accessory unit as long as the appraiser can justify and support such use [analysis] in the appraisal report. Freddie Mac will purchase eligible Mortgages secured by a property with an accessory unit if the appraiser can develop an accurate [credible] opinion of market value for the property.”<sup>31</sup>

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31, Words in [brackets] were added to clarify the meaning in the 5601.12 guideline.



### Best Practice Tip

Another option to provide support for ADUs in the subject market (but not necessarily comparable properties) is to include data on newly constructed properties, not yet sold, that include the option to include an ADU in the build – either attached or detached from the primary dwelling (as an example).

For compliance with Freddie Mac appraisal guidelines and USPAP, such an appraisal report must provide information on the data collected, the research completed, and the analysis determined to justify the adjustment for the subject's ADU. Vague, simple statements or applying an adjustment or even applying no adjustment without an explanation are unacceptable appraisal practices and noncompliant with USPAP.

#### E. Comparable requirements for properties with illegal zoning compliance

“If the subject property accessory unit does not comply with the zoning and land use requirements (illegal zoning), the Mortgage is eligible if:

- The “Site” section of the appraisal report indicates that the accessory unit does not comply with zoning and land use requirements.”



### Best Practice Tip

A clear explanation of how that determination was made must be provided in the appraisal report. For example, what makes the subject specifically illegal with the zoning and/or land use requirements.

- “At least two comparable sales with an accessory unit *must* be included in the appraisal report. The accessory unit of each comparable sale must also be non-compliant with the zoning and land use requirements (illegal zoning) to demonstrate the marketability of the subject property to its market area; and

- The Seller confirms that the existence of the accessory unit will not jeopardize future hazard insurance claims.”<sup>32</sup>

The following FAQs provided by Freddie Mac will assist appraisers in answering questions not covered so far and/or that may not be clear after reading the guideline.<sup>33</sup>

## Accessory Unit FAQs

### Freddie Mac

**Q1. Is a Mortgage secured by a property with more than one accessory unit eligible for sale to Freddie Mac?**

No. A Mortgage secured by a 1-unit property with more than one accessory unit is not eligible for purchase by Freddie Mac. Additionally, a 2- to 4-unit property with one or more accessory units is not eligible.

**Q2. Does an accessory unit need to have a separate entrance independent of the primary unit?**

Yes. Freddie Mac requires an accessory unit to have a separate entrance. Freddie Mac considers an accessory unit to be an additional living area that includes at least a kitchen, a bathroom, a separate entrance and is independent from the primary dwelling unit.

**Q3. Freddie Mac’s definition of an accessory unit states that it must be independent from the primary unit. What is meant by independent?**

Independent in this situation refers to individual living units where each unit has its own separate entrance. An accessory unit may share utilities and common walls with the primary unit.

**Q4. Does Freddie Mac require an accessory unit to have a bedroom?**

No. Freddie Mac does not require an accessory unit to have a bedroom. Freddie Mac will provide financing for properties where the accessory unit is an efficiency unit.

**Note.** In 5601.12, Property Description and Analysis, Freddie Mac addresses the following: Comparable requirements for properties with illegal zoning compliance. It states “If the subject property accessory unit does not comply with the zoning and land use requirements (illegal zoning), the Mortgage is eligible if ....” Therefore, an illegal use is one that is *not allowed* by zoning or land use requirements, nor was the use ever allowed.”

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32. Quoted material in E came from <https://guide.freddie.mac.com/app/guide/section/5601.12>.

33. <https://sf.freddie.mac.com/faqs/accessory-unit-faq>

## **Accessory Unit FAQs, cont.**

**Freddie Mac**

**Q5. What differentiates a 2-unit property from a 1-unit property with an accessory unit?**

The physical features of a 2-unit property and a 1-unit property with an accessory unit can be very similar. To help differentiate these property types, it is important to assess their characteristics and physical features. For example, both 2-unit properties and 1-unit properties with an accessory unit contain two independent units that may also have separate utilities, unique postal addresses, or be rented. Typically, 2-unit properties are constructed at the same time and are similar in size and layout. By contrast, an accessory unit is usually inferior in size to the primary unit. Additionally, accessory units are often created through conversion of an existing garage, basement, or attic space. If there is uncertainty, it might be helpful to contact the appraiser to discuss the specific property characteristics.

**Q6. Is a finished walk-out basement with a bedroom, kitchen, and bathroom considered an accessory unit when there is also access from the primary unit?**

No. A defining factor of an accessory unit is its independence from the primary unit. This means access to the accessory unit must not be possible by passing through the primary dwelling unit. With this scenario, the basement is not fully independent since access to the primary unit is not restricted.

**Q7. Is a finished basement with a bedroom, kitchen, and bathroom considered an accessory unit if access to the basement is through the primary unit and there is not a separate entrance?**

No. An accessory unit is a living area independent of the primary dwelling unit that has a separate entrance.

**Q8. Is it acceptable for an appraiser to ignore the existence of an accessory unit or simply provide no value for the accessory unit when appraising a property with an accessory unit?**

The appraiser's analysis must be documented in the appraisal report and conclude whether an adjustment is necessary for the accessory unit. If the analysis of comparable data (i.e. comparable sales, contract sales (pending sales) and/or current listings) with an accessory unit indicates there is no market reaction to an accessory unit in that market area, the appraiser may reflect no value for the accessory unit. However, to simply ignore the accessory unit due to a lack of comparable sales is not an acceptable appraisal practice.

The appraisal report must justify and support the appraiser's analysis and conclusions.

## 1. Freddie Mac Question and Answer #8

Question 8 is one that is often a weakness in appraisals when “comparable” data is not available. The simple solution, which is not an accurate solution, is to give no value or go even further and ignore the improvement as if it does not exist. As the response to Question 8 states, and is true in this discussion, neither action is compliant with USPAP or Freddie Mac appraisal guidance, and these actions are misleading regarding the subject property.

## 2. USPAP Application to Question 8

USPAP STANDARDS Rule 1-2(e) and Advisory Opinion 23<sup>34</sup> apply to this answer for Question 8. USPAP confirms that even if the conclusion for an ADU is that no value is recognized in the subject’s neighborhood or defined market, such a conclusion *MUST* be supported.

### **STANDARDS RULE 1-2, PROBLEM IDENTIFICATION**

“In developing a real property appraisal, an appraiser must:

- (e) identify, from sources the appraiser reasonably believes to be reliable, the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including:
  - (i) its location and physical, legal, and economic characteristics;
  - (ii) the real property interest to be valued;
  - (iii) any personal property, trade fixtures, or intangible assets that are not real property but are included in the appraisal;
  - (iv) any known easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of a similar nature; and
  - (v) whether the subject property is a fractional interest, physical segment, or partial holding;
- **Comment on (i)–(v):** An appraiser may use any combination of a property inspection, documents, such as a legal description, address, map reference, copy of a survey or map, property sketch, photographs, or other information to identify the relevant characteristics of the subject property.”

**Source:** USPAP, STANDARDS RULE 1-2, PROBLEM IDENTIFICATION

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34. USPAP Advisory Opinion 23, *Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment*. Washington, D.C.: The Appraisal Foundation, 2020-2021 ed.

### **III. U.S. Department of Housing and Urban Development: FHA Single Family Housing Policy Handbook 4000.1**

The following excerpts from Handbook 4000.1 are quoted from pages 152 – 155 of the handbook.

A. FHA's programs differ from one another primarily in terms of what types of Properties and financing are eligible. Except as otherwise stated in this *SF Handbook*, FHA's single-family programs are limited to one – to four-family Properties that are owner-occupied Principal Residences. FHA insures mortgages on real property secured by

- Detached or semi-detached dwellings
- Manufactured housing
- Townhouses or row houses
- Individual units within FHA-Approved condominium projects

B. FHA will not insure single-family mortgages secured by

- Commercial enterprises
- Boarding houses
- Hotels, motels and condotels
- Tourist houses
- Private clubs
- Bed and breakfast establishments
- Other transient housing
- Vacation homes
- Fraternity and sorority houses

## Definitions from Handbook 4000.1

### (1) One Unit

“A one-unit Property is a Single Family residential Property with a single Dwelling Unit, or with a single Dwelling Unit and a single ADU.”

### (2) Two Unit (a) Definition

“A two-unit Property is a Single Family residential Property with two individual Dwelling Units.”

### (3) Three to Four Unit (a) Definition

“A three- to four-unit Property is either:

- a Single Family residential Property with three or four individual Dwelling Units; or
- a Single Family residential Property with two individual Dwelling Units and one ADU or three individual Dwelling Units and one ADU.”

### (4) Accessory Dwelling Unit (a) Definition

“An Accessory Dwelling Unit (ADU) refers to a habitable living unit added to, created within [converted space], or detached from a [primary] one-unit Single Family dwelling, which together constitute a single interest in real estate. It is a separate additional living unit, including kitchen, sleeping, and bathroom facilities.” **Note.** Comments in brackets were added by the seminar developer for further clarification.

**Note.** This means no matter what you call the “additional unit,” it is included in the total number of units. For example, if the subject has three units and an ADU – it is a four-unit property. If the subject has four units and an ADU – it is a five-unit property.





### Best Practice Tip

This latter issue should be discussed immediately with the lender/client, and if necessary, FHA, **BEFORE** proceeding with the completion of the assignment, specifically because it results in a five-unit property, which may disqualify the property as eligible for the loan program for the potential borrower, and the appraiser may not be allowed to value the property under his/her licensure.

#### C. Legal status

Based on interviewing FHA Policy Personnel: The ADU **MUST** comply with zoning and be legally permissible. The appraiser must perform and summarize the results of the highest and best use analysis.

Based on FHA appraisal requirements, is the property

1. Legally permissible
2. Physically possible
3. Financially feasible
4. Maximally productive

#### D. Zoning Standard ( 4000.1 Handbook, Page 545)

FHA requires the Property to comply with **ALL** applicable zoning ordinances.

E. Required analysis and reporting

The appraiser must determine if the current use complies with zoning ordinances.

“If the existing Property does not comply with all of the current zoning ordinances but is accepted by the local zoning authority, the Appraiser must report the Property as ‘Legal Non-Conforming’ and provide a brief [summary] explanation [including what makes the subject non-conforming to the current zoning requirements]. The Appraiser must analyze and [provide a summary explanation in the] report [of] any adverse effect that the non-conforming use has on the Property’s value and marketability, and state whether the Property may be legally rebuilt if destroyed.”<sup>35</sup> (Comments in brackets were added by the seminar developer for further clarification.)

### 3.5 Discussion Question.

*Why do appraisers have to provide an explanation?*



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F. Identifying an accessory dwelling unit

[For] “Required Analysis and Reporting as part of the highest and best use analysis, the Appraiser must make the determination to classify the Property as a Single-Family dwelling with an ADU, or a two-family dwelling. The conclusion of the highest and best use analysis will then determine the classification of the Property and the analysis and reporting required. An ADU is usually subordinate in size, location and appearance to the [primary] Dwelling Unit and may or may not have separately metered utilities or separate means of ingress or egress. The Appraiser must not include the living area of the ADU in the calculation of the Gross Living Area (GLA) of the [primary] dwelling. The Appraiser must notify the Mortgagee of the deficiency in MPR<sup>36</sup> or MPS<sup>37</sup> if more than one ADU is located on the subject Property.”<sup>38</sup>

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35. U.S. Department of Housing and Urban Development, Handbook 4000.1 (Washington, D.C., U.S. Department of Housing and Urban Development, last revised 11/18/2020), P. 549.  
36. MPR – Minimum Property Requirements  
37. MPS – Minimum Property Standards  
38. Ibid., Handbook 4000.1, P. 560. (Words in brackets were added for further clarification.)

**Note.** In an interview, HUD appraisal policy personnel stated that the appraiser must provide a summary explanation of how the determination that the subject is a one-unit property with an ADU instead of a two-unit property is clearly the highest and best use.

#### G. Comparable sale requirements

An interview with HUD policy personnel provided the following tip:



#### **Best Practice Tip**

FHA, ideally, anticipates the sales comparison approach will include at least one comparable sale with an ADU. If this is not possible, the appraisal report must provide an explanation of how the ADU adjustment (or lack of an adjustment) was determined. This requires an explanation of the data collected, research completed, and analysis determined to support the adjustment applied. Per FHA, it is an unacceptable appraisal practice to apply an across-the-board adjustment in the sales comparison grid without support.

**Summary:** “The theme in all the secondary mortgage market appraisal guidelines and government appraisal requirements is [that] a highest and best use analysis of the subject property [must be provided and summarized in the appraisal report]. It is imperative that the subject’s legal and physical relevant characteristics are examined, analyzed, and a conclusion developed that determines if the subject is a one-unit property with an ADU or a two-unit property (no ADU), at a minimum. This is also necessary to complete the remaining aspects of the highest and best use analysis, including the subject’s market reaction to ADUs (i.e., positive, neutral, or negative). From this, an appropriate scope of work can be developed that also considers the intended user’s applicable appraisal guidelines or requirements in order to develop credible assignment results.” (Words in brackets were added for clarification.)

#### IV. Veterans Administration (VA): Secondary Mortgage Market Appraisal Guidelines and ADUs

- A. The VA guidance on valuing ADU properties differs from the Fannie Mae and Freddie Mac appraisal guidelines. The information on VA requirements (3.6 Table) was quoted from VA Pamphlet 26-7, Revised Chapter 11, Appraisal Report VA.

<b>3.6 Table. Accessory Dwelling Unit</b>	
<b>Change Date</b>	February 22, 2019  ▪ This Chapter has been revised in its entirety.
<b>a. Single Real Estate Entity</b>	An Accessory Dwelling Unit (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.
<b>b. Highest and Best Use</b>	As part of the highest and best use analysis, the appraiser must determine if the property is a single-family dwelling with an ADU, or a two-family dwelling. The highest and best use must be a legal use (see Topic 10). A two-family dwelling must be appraised on the Fannie Mae Form 1025, Small Residential Income Property Appraisal Report.
<b>c. ADU Valued Separately</b>	An ADU is usually subordinate in size, location, and appearance to the [primary] dwelling unit and may or may not have separately metered utilities and separate means of ingress and egress. The appraiser must not include the living area of the ADU in the calculation of the GLA of the [primary] dwelling. The ADU must be valued separately as a line item on the market data grid.
<b>d. Notify the Lender if More than One Unit</b>	The appraiser must notify the lender if a property has more than one ADU.
<b>e. Detached Buildings</b>	A manufactured home, shed, or other detached building on the property which does not have kitchen, sleeping, and bathroom facilities or cannot be legally used as a dwelling, may be valued as storage space if it does not present any health or safety issues. <sup>39</sup>

39. Veterans Administration, Lenders Handbook – VA Pamphlet 26-7, Chapter 11, [https://www.benefits.va.gov/warms/pam26\\_7.asp](https://www.benefits.va.gov/warms/pam26_7.asp).

## B. VA requirements according to the guidelines

- Must be a legal use (6. B.)
- The dwelling and ADU together constitute a single real estate entity.
- Must be valued separately as a line item on the market data [sales comparison] grid (6.c.)
- An ADU living area must not be included in the [primary] dwelling.
- Must notify the lender if a property has more than 1 ADU



### Best Practice Tip

The revised VA appraisal requirements do not provide the same level of detail provided by Fannie Mae and Freddie Mac for ADU circumstances not addressed or those that are addressed but with less detail. As a result, if these requirements do not answer issues that are found during the inspection (or, e.g., desktop appraisal assignment, etc.), the appraiser should contact the VA for specific assistance and advise the lender(s). The appraiser should **NOT** attempt to make valuation determinations without additional assistance from the VA. Otherwise, the appraiser will likely have to redo the appraisal work and appraisal report after review. It's important to document all communication with the VA and/or lender in the appraisal report and/or workfile.

## V. Excerpt from VA Pamphlet 26-7, Revised (Change Date: Feb. 22, 2019) Chapter 11, Appraisal Report: Sales Comparison Approach

### A. Comparable sale selection

“The appraiser must include, at a minimum, three closed sales which the appraiser believes are the best available sales and provide comments to support the selection, when appropriate. Comparable sales should be selected based on similar locational and physical characteristics, not sales price. Recent sales in the same established subdivision, condominium or PUD are typically the best indicators of value. The sales should be similar to the subject property to the extent that the sales would be competing properties if they were on the market at the same time as the subject property.”

## B. Comments explaining adjustments

“The appraiser should provide comments when adjustments are made for points of comparison that are not self-explanatory or when large adjustments are made. Providing detailed commentary about the market and comparable selection may reduce the number of requests for revisions of appraisals.”

## C. Limited sales data

“If the sales data from the market area is limited, the appraiser must provide the best information available and comments with the appraiser’s professional opinion about the market, any reasons for the lack of sales data, and the various differences between the subject and the comparable sales.”

## **VI. Comparison of Secondary Mortgage Market Appraisal Guidelines and Government Agency Appraisal Requirements**

The following overview of the lending appraisal guidelines regarding single-unit properties with ADUs illustrates that the determination of the intended use and user are essential parts of the appraisal process. Not all appraisal guidelines are the same, and a lender/client may have a different guideline as well. **Note.** These guidelines are for lending purposes and would not apply to a client outside the lending world. The intended use and intended user help to determine which appraisal guidelines or requirements apply.

**3.7 Table. All data is current as of 1/28/22**

	<b>Fannie Mae</b>	<b>Freddie Mac</b>	<b>Veterans Administration</b>	<b>Housing and Urban Development (FHA)</b>
<b>ADU defined in the guidelines</b>	Yes	Yes	Yes	Yes
<b>Must be legal to be eligible for financing</b>	No	No	Yes	Yes
<b>ADU cannot be included in GLA of primary structure</b>	Correct	Correct	Correct	Correct
<b>Must be owner-occupied</b>	No	No	Yes	Yes
<b>Is ADU required to have a kitchen, bathroom, bedroom, and living area?</b>	Bedroom not required (can be an efficiency)	Bedroom not required (can be an efficiency)	Bedroom not required but sleeping area is.	Bedroom not required but sleeping area is.
<b>Must ADU have building permit to be eligible for financing?</b>	No	No	Yes	Yes
<b>Is separate meter and address required for ADU?</b>	No	No	No	No
<b>Does an attached or converted space ADU require a separate access from the primary dwelling?</b>	Yes	Yes	Not required	If required by zoning.
<b>Is an ADU used as a short-term rental eligible for financing?</b>	Yes	Yes	Yes, if it remains residential	May if HBU classifies it residential
<b>Is a 2- to 4-unit with an ADU eligible for financing?</b>	No	No	No	No
<b>Legal Use—# comparables with ADUs required in sales comparison grid. Note. All require 3 or more comparables in the sales grid with support for adjs.</b>	1 w/ADU*	1 w/ADU min.	3 closed sales, best available	1 w/ADU minimum

**3.7 Table, cont.**

	<b>Fannie Mae</b>	<b>Freddie Mac</b>	<b>Veterans Administration</b>	<b>Housing and Urban Development (FHA)</b>
<b>Illegal Use—# Comparable sales with ADUs required in sales comparison grid. Note. All require 3 or more comparables in the sales grid</b>	2 w/ illegal ADUs	2 w/illegal ADUs	N/A	N/A
<b>Dated sales accepted as comparables</b>	Yes	Yes	Yes	Yes
<b>Listings, pending sales accepted to show marketability &amp; market reaction</b>	As additional exhibits	As additional exhibits	As additional exhibits	As additional exhibits

\* While the Fannie Mae Appraisal Guidelines require no “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 might also be required by lenders.



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 **3.8 Exercise** 

**Data Limitations**

Data are limited in many markets because of a variety of reasons. Limitations may include the following. Think about your experience with data and add more limitations to the list.

- ADUs have a wide variety of names.
- Data sources seldom have standardization of the data for this improvement type.
- Data sources often have no searchable data field.
- Data sources such as public property records often do not identify the ADU improvement. Instead, they identify it inaccurately as a shed.
- .....
- .....
- .....
- .....

Part 4 explores the data challenges in more detail.

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 **3.9 Exercise** 

What are the common differences between zoning requirements and secondary market appraisal requirements (and government agency requirements) for properties with ADUs? Complete the table below by filling in the columns as needed.

<b>Common Differences Between Zoning and Secondary Market Appraisal Requirements (and Government Agency Requirements) for Properties with ADUs</b>		
	<b>Zoning</b>	<b>Secondary Market/Govt. Agencies</b>
<b>ADU square footage</b>		
<b>ADU rooms</b>		
<b>Private entrance required</b>		
<b>Site size</b>		
<b>Legally permitted</b>		
<b>Parking requirements</b>		
<b>ADU can be rented</b>		

**Note.** Be careful about using the following words alone--*permit* or *permitted*--because they can be misinterpreted. Be specific by using terms such as *legally permitted* or *obtained a building permit*.

### 3.10 Dilemma



**Review the 1004 Appraiser Certification and Identify Items That Require Attention in the Appraisal.**

**Certification 3.** I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

**Question:** *How do appraisers certify to this statement when the secondary lending guidelines define an ADU differently than the zoning jurisdiction?*

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### 3.10 Dilemma, cont.

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**Review the 1004 Appraiser Certification and Identify Items That Require Attention in the Appraisal.**

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## Learning Objectives

Now that you've completed Part 3, you should be able to

- Identify financing guidelines that affect valuation.
- Recognize USPAP standards that apply.
- Understand the data limitations.

## Terms and Concepts to Remember

Airbnb	Traditional bed & breakfast	Two- to four-unit property
Legal nonconforming	(Transient) boarding house	Vrbo®
Relevant characteristics		

## Recommended Resources

*Fannie Mae Selling Guide*, Part B, Subpart B2, Eligibility Chapter B2-3, Property Eligibility dated 9/1/2020 and B4-1.3-05.

Freddie Mac Accessory Dwelling Unit FAQs.

*Freddie Mac Selling Guide* Section 5601.12, 5601.120(e)(v) A. and B.

*Housing and Urban Housing Development, Handbook 4000.1*, dated 11/18/2020, P. 152–155.

*Veterans Administration Lenders Handbook*, VA Pamphlet 26–7, Chapter 11.



## Data Challenges That Complicate the Assignment

Properties with features that are new to the market or that have not been identified or not easily identified in common data sources create challenges in developing supportable opinions of value. A local MLS does not always have searchable fields to identify ADU properties. Public records may not separate the ADU living area from the primary structure. These challenges complicate the appraisal assignment and the ability to meet the appraisal guidelines or requirements as well as USPAP standards. In this part, we will review various data sources and key search words that might assist in identifying ADU properties.

## Learning Objectives

To prepare for Part 4, read the following learning objectives and refer back to them as you study this part.

- Recognize MLS data challenges.
- Identify the limitations of public property records.
- Understand the importance of developing an appropriate scope of work.

## Learning Tips

In Part 3, we learned the importance of identifying the relevant property characteristics to determine the subject's property type and ability to develop a supportable highest and best use that accurately illustrates the subject property's market reaction to an ADU. The data required to value the property is complicated for a variety of reasons. Part 4 provides tips on how to search for relevant data that goes beyond the standard searchable MLS fields. During this discussion, class participants will work together to brainstorm tips that have worked in their market when searching for unusual improvements, less common improvements, or properties with cutting edge new improvements.





# Part 4.

## Data Challenges That Complicate the Assignment

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### I. Multiple Listing Service (MLS) Data Challenges

- A. 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. See Certification 12 below.<sup>40</sup>



#### Appraiser Certification on the Fannie Mae Form 1004:

**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.

1. The MLS is a data service for the specific use of buying and selling properties. As a result, it is a valuable data source for appraisers, where it is available.
2. As useful as MLS commonly is to an appraiser's daily work, most appraisers have experienced searchable fields that are not populated or accurately populated. However, even if the local MLS has data integrity issues, it can provide leads to properties that are listed, sold, pending, expired, and withdrawn for further investigation. MLS usually gives more detailed information than the public assessor property records.
3. Not all MLS systems will have data entry or searchability for special improvements such as ADUs. It may require some ingenuity on the appraiser's part, including the use of word searches to find comparable sales, listings, pending sales, or other useful transaction data.

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40. See Advisory Opinion 24 "Normal Course of Business" for additional clarification regarding an appraiser's data source obligations to the intended user and intended use in an appraisal assignment.

B. Possible word search options that can be used in a local MLS to identify ADU transactions.

Word Search Options	Common Word Search Results
Basement	Living quarters Apartment Auxiliary dwelling unit
Interior features	Auxiliary dwelling unit (common if the ADU is part of the primary dwelling)
Exterior features	Auxiliary dwelling unit (common if the ADU is a separate structure from the primary dwelling)

C. Findings vary considerably from MLS to MLS, but if your search under one of the above word searches (or a different word search) results in finding properties with ADUs, the following details may also be included in the MLS data. Otherwise, such data will require investigation in order to properly analyze the subject's property's ADU improvement against the MLS ADU improvement search results. Such investigation might include contacting the real estate agent or agent's selling office, the seller, the buyer, etc. Further, you may need to expand your search to include not only one-unit (e.g., single-family searches) but also other searches for other words. Your search words will depend on how your local MLS might qualify a property with an ADU. For example, consider the above word searches under multifamily and even commercial property search categories. Below are a few details that might be included about an ADU property from an MLS search.

1. Building dimensions
2. Approximate square footage
3. Bedroom count
4. Bathroom count
5. Year built
6. Roof type and building material
7. Construction type/Building material
  - a. Aluminum
  - b. Concrete block stucco

- c. Lap Siding
- d. Wood frame
- e. Steel frame
- f. Full or partial basement
- g. Crawl space
- h. Slab foundation

8. Features

- a. Gas hookup
- b. Parking
- c. Sprinkler
- d. Kitchen
- e. Separate electric meter
- f. Solar panels for electric
- g. Storage
- h. Flooring
- i. Heat/Cooling
- j. Separate water meter
- k. Laundry facilities
- l. Separate entrance
- m. Separate drive

D. A word search of the MLS may be the only way to effectively identify potential properties with ADUs. Some appraisers may not be proficient in using their local MLS or in conducting MLS word searches. The following example demonstrates how to use an MLS using the Matrix™ system. Many local MLS systems may be similar.

## Using the Matrix™ System

1. Click on the Add/Remove to add Public Remarks to allow searching the public remarks describing the property.

### Additional Fields Add/Remove

2. Click on Public Remarks and the Add tab in the center to move it to the Selected Fields

Available Fields		Selected Fields
Previous Status		Zoning
Price Change Timestamp		HERS
Projected Completion Date		Water Access Y/N
Property Attached Y/N		Water Frontage
Property Condition		Association Amenities
Property Description		Appliances Included
Property Style		Green Certification
Property Type		Green Energy Generation
Public Remarks	<input type="button" value="Add -&gt;"/>	Green Energy Features
Public Remarks Spanish	<input type="button" value="Remove &lt;-"/>	HOA Fee
Range		Public Remarks
Realtor Information		
		<input type="button" value="Move Up"/>
		<input type="button" value="Move Down"/>

Search:

3. In the Public Remarks field, type the word or words that might be used for ADUs. It may take several searches changing the words to find all that might apply.

Public Remarks	<input type="text" value="guest house"/>	<input data-bbox="1117 1150 1157 1203" type="button" value="?"/>
Public Remarks	<input type="text" value="in-law"/>	<input data-bbox="1117 1224 1157 1276" type="button" value="?"/>
Public Remarks	<input type="text" value="accessory dwelling"/>	<input data-bbox="1117 1297 1157 1350" type="button" value="?"/>

4. Once you click the return button, it may take a few minutes to find the words. You might want to narrow the search to solds, listings, expired, and/or a given city.

Appraisers who are knowledgeable about the area in which the subject property is located will likely recognize the names of real estate agent(s) who input adequate (or inadequate) listing descriptions into the MLS system. What do you think of the following descriptions from a local MLS system for properties with an ADU? Do you consider the data entry good, neutral, or poor? Are these types of entries commonly found in your local MLS? If you only see the following words: “Detached Casita,” what would you typically do to obtain more information? Read the descriptions and answer the questions on the page that follow them.

## 4.1 Dilemma



### (Property A)

“This renovated home is 90%+ new, highly energy efficient, in Uptown! Main Home: 1,848 sf (2BR, 2BA + Den); Detached Casita: 613 sf (incl. Kitchenette, BA & closet) + 2 Car Garage! Great floor plan with Living/Dining & separate Family Room. Porcelain tile flooring t/out. Gorgeous Kitchen featuring contrasting Soapstone and Quartz counters. MBR w/well appointed Bathroom. Super spacious casita well-suited for personal use, long term rental or high-end Airbnb-\$\$\$! Enjoy all new sewer, plumbing, electric, roof, HVACs, finishes and more in a charming No. Central ranch home. From insulation to air sealing, dual pane windows, and more, this home earned a 63 HERS score - meaning high energy efficiency and low electric & gas bills. This home also was awarded Gold level Pearl Certification for its energy efficiency characteristics. All work by licensed contractor, fully permitted by City of Phoenix.

Located in a great Uptown location, close to Uptown Plaza, St. Francis, Light Rail, Postino’s, Windsor, Joyride, Federal and on and on.. Charming, friendly street with much pride of ownership.

Refer to Scope of Renovations, Floor Plan, and HERS Test report in Docs tab.”

### (Property B)

“Main house is energy-efficient, low HERs score/all shopping minutes away/freeway to CBD<1 mi./approved detached in-law unit includes a kitchen, bathroom, bath, & living room/public records 750 SF/huge plus unit can be legally rented with lease or used as Airbnb per owner/Income from unit can be provided upon request.”

*What did you conclude from reading the MLS descriptions?*

#### **Property A.**

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## 4.1 Dilemma, cont.



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### Property B.

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**Note:** See Digging Deeper at the end of Part 4 for more information on the HERS energy ratings and where to verify them.

## II. Public Property Records

- A. The public property records are a little (or a lot) more challenging to search, depending on the quality of your local assessment data). Below are a few ways properties appear in the assessor's records, and some might be similar to the records in your location. Reviewing the following examples will give you a better understanding of ways to identify ADUs in public property records.

### 1. Illustration 1

MLS data: MLS search identified a listing of a property in Charlotte County with a "guest house." No other information.

Public property data: Property type: "Single-unit" (2)

Current use: (Multi-single-units (2) Single-unit residences; Single-unit residence and mobile home; or (2) Mobile homes

### 2. Illustration 2

MLS data: 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 property record data: Found property from the MLS by address in the public property record data, and it identified the following:

Property type: Single-unit

Additional features: None

Building area: 1,784 square feet

Other building(s): 700 square feet

The public property record incorporates the ADU living area in the primary house square footage.

**Note.** To avoid major errors, be aware of how the living area is identified. Always verify your data with other sources. The listing of the comparable sale used the assessor's square footage of 1,784 sq. ft.; however, the ADU square footage was 700 sq. ft. and included in the primary house. How might this create errors? Or, assume you believe the primary house is 1,784 sq. ft., you do not verify this information with other sources, and you use this information to identify this property as a comparable sale in the sales comparison grid.



## Some Questions to Consider

*How might the square footage issue in Illustration 2 create errors?*

**Note.** Assume the listing states that the primary house of this comparable sale is 1,784 sq. ft., and your comparable sale search parameters include houses between 1,500 sq. ft. and 2,000 sq. ft. However, in reality the living area of the primary house is 1,084 sq. ft.

Answer the following questions:

Question 1: *Using this search parameter, would the data identified be comparable sales that would compete for the same buyer?*

Question 2: *What is the likelihood of an underwriter discovering this error about this comparable sale?*

Question 3: *Is it acceptable to use only one data source to determine the improvement characteristics of a comparable sale? What this specific comparable sale?*

Question 4: *If you know that information from one data source is not the same as information from another data source for this comparable sale, should this discrepancy be identified in the appraisal report? Should the appraiser explain in the appraisal report how this discrepancy was reconciled to ensure that the most reliable data was used? (See Certifications 12 and 15.)*

Question 5: *Do these factors suggest that appraisal assignments that include a property with an ADU may take more time to research, require greater verification of the data and the use of more than one data source, and require experience in this property type and its geographic area to develop a credible value opinion?*

### 3. Illustration 3

MLS Data: MLS search identified a historical bungalow with an upstairs “in-law suite from the back.

Compare MLS to Property Public Data: Found property from the MLS by address in the public property record data and it identified the following:

Single-unit. (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

B. These illustrations show how difficult it can be to identify properties with ADUs. They also emphasize the following:

- Why competency in valuing properties with ADUs is necessary
- Why geographic experience and knowledge in a market is important (An appraiser needs to use multiple data sources to verify the information about ADU comparable sales.)
- Why one data source is not adequate to obtain property information

Some data sources do not provide accurate or complete information about property improvements. Multiple data sources are necessary, and data needs to be verified with primary sources. This effort needs to be accomplished, or at a minimum attempted, by the appraiser to ensure the work that is completed results in credible opinions and conclusions and does not mislead the client/intended user.

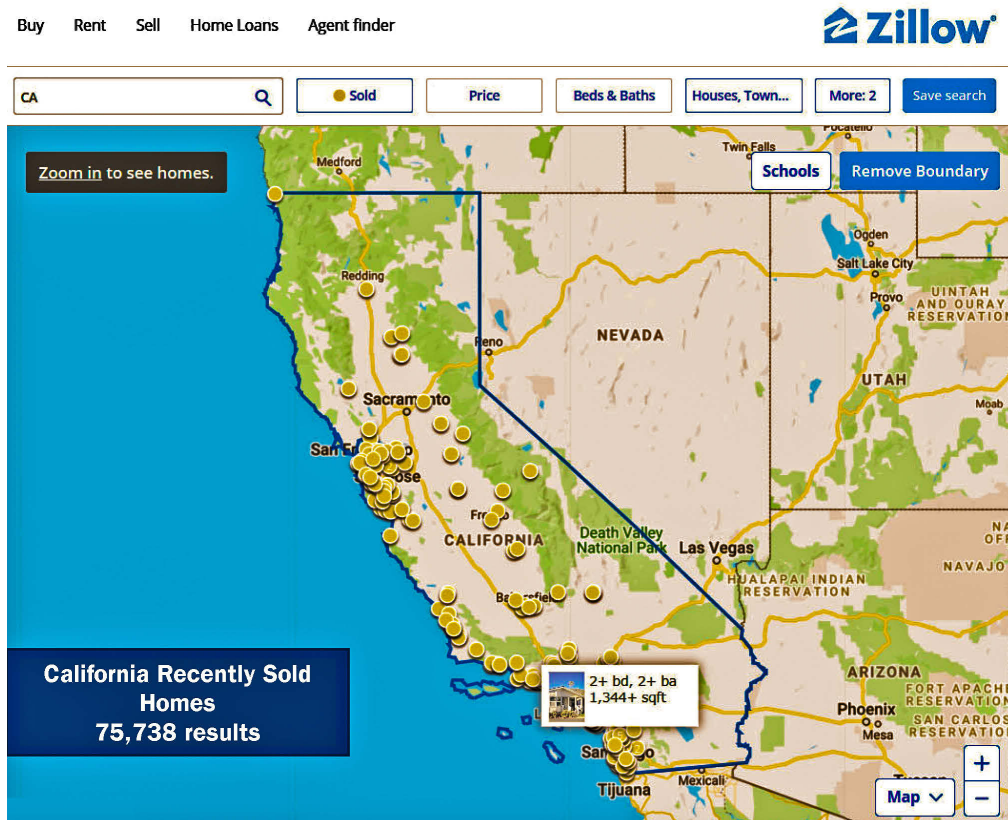
### **III. Other Real Estate Search Platforms**

Technology provides us with multiple sources to identify properties with various features such as ADUs. With that said, appraisers should be open to using the following real estate platforms, which are available in most, if not all markets. These platforms can be valuable search tools for properties with ADUs.

- A. Zillow.com. Zillow is a free and well-known internet-based real estate search platform that is often used by buyers and sellers in the market to obtain a “guesstimate” of a property’s “value.” Zillow does collect both MLS listing and sold 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.
1. If you are unfamiliar with Zillow, in simple terms, the product uses algorithms to produce estimated values, which many appraisers frown upon. However, it can be a valuable search platform and data source for listing, sold, and leased properties. The following search example is very informative. It demonstrates an understanding of trends and data that can be overlooked if an appraiser enters very narrow search parameters, uses a single source for real estate transactions, fails to verify the improvement data information with multiple sources, or is resistant about using this data source.

The following parameters were placed in the Zillow search bar.  
 (https://www.zillow.com/)

Steps in Zillow.com Search		
Date: 4/3/2021	Tab	Selection
Opening search:	“Address”	California
First tier search options:	“Buy” (Top left tab above map)	“Recent Home Sales”
Second tier search options:	“Home Type” (Top of Map)	All but “Apartments,” “lots/Land”
	“More”	“Sold in Last” – “36 Months”
	“More”	“Keywords” – Typed in “Guest House”
	“More”	Click “Done”
Search results		75,738 Properties (See map following)



Date checked: 4/3/2021<sup>41</sup>

Source: https://www.zillow.com/

41. Date check: April 3, 2021. **Note.** Changing the parameters to a specific city; for example, “Concord, CA,” the search results dropped down to 5,172 properties, and when the appraiser provided a specific area in Concord (not an address, but area) – “Cowell, Concord, CA,” the search results dropped further to 57 properties.

## 2. Change search results:

- If the appraiser changes *Keywords* –“Guest House” to “Accessory Dwelling Unit,” only 1,625 properties in California meet this criterion.<sup>42</sup>
- Change search results: If the appraiser changes *Keywords* - “Accessory Dwelling Unit” to ADU, it results in 11,602 properties in California that meet this criterion.<sup>43</sup>
- Change search results: If the appraiser changes *Keywords* to JADU, it results in 36 properties in California that meet this criterion.<sup>44</sup>

B. Realtor.com: Another free and well-known internet-based real estate search platform, again, often used by buyers and sellers in the market to find homes to buy, lease, and sell. Unlike Zillow, it does **not** provide “guesstimates” of value of a specific property. However, like Zillow, it aggregates data based on multiple data sources into one location. Data aggregation includes MLS, public property records, local data consortiums regarding schools, etc. The following search example was equally informative. It also provided a wider understanding of trends and data that can be overlooked if an appraiser enters very narrow search parameters, uses a single source for real estate transactions,<sup>45</sup> fails to verify the improvement data information with multiple sources, or is resistant about using this data source.

### 1. The following parameters were chosen and placed in the Realtor.com search platform (<https://www.realtor.com/>).

- Opening Page – Chose option “Buy”: to review properties listed for sale and enter the city, state, or specific property address into the search bar.
- Address: Phoenix, AZ
- First tier search options
  - Property Type – All but “Any,” “Farm,” “Mobile,” and “Land”
  - Listing Status – “Existing Homes” (But there are other options like “New Construction,” “55+Community,” “Foreclosure.”)

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42. Keeping the location parameters to “Cowell, Concord, CA” but changing the Keyword search to “Accessory Dwelling Unit” does not change the results from the prior footnote of 57 properties.

43. Keeping the location parameters to “Cowell, Concord, CA” but changing the Keyword search to “ADU” results in the response: “no matches.” Date Checked 4/3/2021.

44. Keeping the location parameters to “Cowell, Concord, CA” but changing the Keyword search to “JADU” results in the response: “no matches.” Date Checked April 3, 2021.

45. Realtor.com will allow additional parameters, as the illustration identifies, to be added in the “Buy” option; in other words, properties listed for sale. This option to write in a search parameter is **not** available under the “Sold Homes” option.

- Search Results: 3,717 homes listed for sale.<sup>46</sup> Try to filter the search further with the following options:
  - More Filters – “Keyword Search,” Typed in “Guest House.” Search results: 68 listed properties.
  - Alternate More Filters – “Keyword Search,” Typed in “ADU,” “In-Law,” “Granny Unit,” or even “Canista” (a common word in the Phoenix area for a separate structure per MLS); search results were 0 (no matches).
  - Conclusion: The 68 listed properties could be further filtered by using More Filters – “Expand Search”: and either “Search Radius in Miles” or “Include Nearby Areas,” best associated with the location of your subject property.
- 2. Although the data are listings and not sales, this information will support that ADUs exist in the subject market and can further help appraisers to support information on ADUs by investigating the listings with their real estate agent and public record data and assist also in finding sales of ADU properties. Like Zillow, if a property sells, and there is an MLS listing, Realtor.com will post that MLS data in its database.
- 3. The exercise and discussion on search platforms demonstrate that there are many names in the market for ADUs. It is the appraiser’s responsibility to be competent and know what names/options/keywords should be used to ensure that the collection, research, and analysis of data is complete and accurate. In the search for available data and data source, using only one data source or one phrase for ADUs, as well as failing to verify data from primary sources, could result in opinions and conclusions that are not supported. This can bring up issues with the appraiser’s client and also the state appraiser enforcement agency.
- 4. Appraisers must do the following to result in a scope of work that leads to supported and credible assignment results:
  - Be current and knowledgeable about terms to use in the data search
  - Be competent in the subject market and the ADU property type
  - Complete a thorough highest and best use analysis

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46. Date checked: April 3, 2021.



## Digging Deeper

### 1. Uniform Standards of Professional Appraisal Practice (USPAP): Standards and Rules That Apply

#### STANDARDS RULE 1-2(h)

“In developing a real property appraisal, an appraiser must

(h) determine the scope of work necessary to produce credible assignment results in accordance with the SCOPE OF WORK RULE.”<sup>47</sup>

The appraiser must determine the scope of work necessary to develop an appraisal that is credible given its intended use.

#### SCOPE OF WORK RULE

##### SCOPE OF WORK ACCEPTABILITY

“COMMENT: The scope of work is acceptable when it meets or exceeds:

- the expectations of parties who are regularly intended users for similar assignments; and
- what an appraiser’s peers’ actions would be in performing the same or a similar assignment”<sup>48</sup>

Included in the introduction to the SCOPE OF WORK RULE is an elaboration of the definition of the scope of work.

“Comment: Scope of work includes, but is not limited to:

- the extent to which the property is identified;
- the extent to which tangible property is inspected;
- the type and extent of data researched; and
- the type and extent of analyses applied to arrive at opinions or conclusions.”<sup>49</sup>

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47. USPAP: STANDARDS RULE 1-2(h), (Washington, D.C. The Appraisal Foundation, 2020-2021 ed.). For more information, see Advisory Opinion 28, Scope of Work Decision, Performance, and Disclosure and Advisory Opinion 29, An Acceptable Scope of Work.

48. APPRAISER’S PEERS: “Other appraisers who have expertise and competency in a similar type of assignment. USPAP: DEFINITIONS, (Washington, D.C.: The Appraisal Foundation, 2020-2021 ed.) Also see Advisory Opinion 28, Scope of Work Decision, Performance, and Disclosure.

49. USPAP: SCOPE OF WORK RULE, (Washington, D.C.: The Appraisal Foundation, 2020-2021 ed.).



## Digging Deeper, cont.

- A. The challenges identified in Part 4 should be described in the scope of work. A scope of work can be in one section of your report or provided throughout your report from section to section. **Reminder:** Your scope of work must provide credible assignment results based on the intended use, and the reporting of your scope of work must not mislead your client/intended user.
- B. 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. The scope of work requirements, shown on the next page, are from the Fannie Mae 1004/Freddie Mac 70 Appraisal Report dated March 2005.

**Note.** The GSEs are currently updating the appraisal report forms, and the language in the new design may change from the current forms.

**Reminder.** The appraisal guidelines and scope of work in the GSEs do not limit the appraiser to only the following statements. "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;
- The extent to which the property is inspected, including the site and all the improvements, and what you did not inspect is equally important to disclose;
- The type and extent of data researched by the appraiser because data used to determine the market conditions is not the same data [used] to determine what sales are comparable to the subject [property] 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 to 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."<sup>50</sup>

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50. Stephanie Coleman, MAI, SRA, AI-GRS, AI-RRS, *Scope of Work*, Third Edition. (Chicago: Appraisal Institute, 2020), P. 20.



## Digging Deeper, cont.



### 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.”

**Source:** Fannie Mae 1004/Freddie Mac 70 form dated March 2005

## 4.2 Discussion Question

*Does this scope of work discussion accurately describe the steps necessary to develop a credible value opinion for a single-unit house with an ADU? If not, what is missing?*



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## Digging Deeper, cont.

### 4.2 Discussion Question, cont.

A series of horizontal dashed lines provided for writing a discussion response.



## Digging Deeper, cont.

### 4.2 Discussion Question, cont.

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## 2. Examples of Well-Developed Scope of Work Sections

The *Scope of Work*, Third Edition, by Stephanie Coleman is a good resource for developing the scope of work wording for a variety of assignments. Below are some examples that might apply to a property with an ADU. They are adapted from examples from the *Scope of Work*, Third Edition.

- A. Physical characteristics



## Digging Deeper, cont.

- I viewed the interior and exterior of the subject improvements that included an ADU in order to gather information about the physical characteristics of the subject improvements that are relevant to the valuation problem.
- I measured the subject improvements to calculate the gross living areas (GLA) of each unit. A sketch and my calculations are included on page (#) of this report. The GLA in this report differs from the MLS and property assessor's records because both include the ADU living area in the main dwelling unit's living area.
- I read the building inspection report dated mm/dd/yyyy completed by (inspector name), and it's included in my workfile to better understand the property condition conclusion in the appraisal report.

### B. Legal characteristics

- I relied on the title report prepared by (name) on (mm/dd/yyyy) for information regarding easements, covenants, restrictions, and other encumbrances. I did not research the presence of such items independently.
- This report has been completed without a boundary survey to identify possible encroachments or easements. From visually inspecting the property, along with public property record data, and viewing the street and aerial photography, none were visible.
- I obtained information about the subject's zoning, likelihood of a zoning change, and the legal status of the existing ADU from (name) at the (city name) Planning Department on (mm/dd/yyyy).



## Digging Deeper, cont.

### C. Economic characteristics

- I examined the ADU lease between (lessor) and (lessee) dated (mm/dd/yyyy) concerning the subject property to identify its terms and conditions.
- I researched the zoning to learn the legal ability to rent the ADU and researched comparable ADU properties to estimate the ADU market rent.
- I researched the operating expenses of comparable properties in order to estimate ADU operating expenses.

### D. Type and extent of data

- I researched sales of properties similar to the subject property that have occurred over the past (time period) in (geographic area). Sources include the local MLS, property tax records, public property records, Zillow.com, other appraisers, and my own files.
- I researched data on comparable land sales and site sales using county records and data from my own files. I verified each sale with one or both parties to the transaction and/or their real estate agents. A summary of the data collected and verification source(s) are detailed in the sales comparison grid and summary comments.  
(**Note.** It is highly recommended that detailed data sheets for the comparable data or other data used in the approaches to value be provided in the appraisal report as an exhibit if the sales comparison grid or summary do not provide the detailed explanation).
- I located (xx) sales, (xx) pending sales, and (xx) listings in the subject property's market area searched in MLS. Of these single-unit sales with ADUs, the (xx) most similar sales were used in the sales comparison approach, and these included sales that were more than a year old due to the limited ADU sales of recent date. Appropriate market condition adjustments were applied based on the sale price trends. A summary explanation of the trending analysis and its application to each comparable sale is in the sales comparison addendum.



## Digging Deeper, cont.

### D. cont;

- I verified the data with parties involved where possible, as disclosed in the sales comparison grid with details provided in the summary comments. Sale parties for Comparable(s) X,X,X ... could not be reached or did not respond to multiple attempts to provide a personal verification of [identify] the issues that were not verified. However, the adjusted sale price(s) of Comparable(s) X,X,X ... fall within the range of the verified data, giving support for their use in the analysis of the subject property's final value conclusion.
- In the cost approach, replacement cost was used to develop a value indication for the subject property due to the age and construction style of the improvements.
- The replacement cost for the subject property has been estimated via the cost-estimating service technique using (name of service) with actual costs from prior appraisals used for additional support or from the cost breakdown provided by the builder. This data is included in the addendum. **Reminder.** The appraisal report forms require that the cost approach opinions and conclusion **can** be replicated by the client/intended user. To do that using the data sources cited, you must provide that data with an explanation of how it was applied to develop the opinions and conclusions in the cost approach.
- In order to arrive at an opinion of the market value of the subject property, I researched the market for ADU transactions including sales, pending sales, and listings as well as expired and withdrawn listings. Because I found no sales in the subject property's market area, it was necessary to expand the search to a market area with similar market characteristics. (Name the market area and provide a summary of how and why it was determined that this market area is similar to the subject property's neighborhood/market.) The lack of transactions is not an indication of a negative or limited market reaction for properties with ADUs. Legal conforming ADUs like the subject property are few because the zoning ordinance did not allow them prior to (XXXX). The change in zoning and increased demand for affordable housing has spurred the building of ADUs on improved properties in neighboring single-unit zoned market areas, but sales of such properties have not yet occurred.



## Digging Deeper, cont.

### E. Type and extent of analysis applied

- In order to determine the highest and best use of the real estate, I completed a survey of the market specifically for housing supply and demand factors and to conclude an opinion on the market reaction to properties with ADUs. The data researched and analysis completed are summarized in this Appraisal Report and are the basis for my conclusion of the highest and best use.
- Due to the subject improvement having a legal nonconforming ADU, the appraisal problem required a more intensive highest and best use analysis. The results of my data collection, research completed, and analysis identified that the building of ADUs has increased in the subject's neighborhood and market area in the (time frame). The data researched and analysis completed are summarized in this Appraisal Report and are the basis for my conclusions of the highest and best use.
- I developed a value indication(s) using the (e.g., sales comparison, cost, and/or income capitalization) approach(es) and provided a reconciliation discussing the quality and quantity of data available to explain how the approach to value and final opinion of value were developed for the subject property.
- I did not develop the income approach because there were insufficient comparable rental properties available as well as recently sold in the subject neighborhood. In reviewing public property records and tax assessment data, the number of properties in which the owner's address did not match the mailing address of a property in the subject's neighborhood was less than 2%. This clearly identified an owner-occupied neighborhood. Also, in verifying sale data with local real estate agents, they further confirmed that rental properties and/or sold rental properties were nonexistent. From this data, I concluded that the income approach was neither applicable nor necessary for credible results.



## Digging Deeper, cont.

### E. cont.

- I did develop the income approach because there were sufficient rental properties in which I was able to obtain the lease and sale data through discussions with the owners or real estate leasing managers. Further, some of the rental and lease properties included an ADU rental. All the leases reviewed or discussed were annual contracts. The rental property sales occurred in the last 12 months, and the rental sales with ADUs sold in the last 6-months. This information was verified with the owners and/or real estate agents. Further, half of the rental properties included an ADUs rental, like the subject property; the subject's main improvement and ADU are both rented. A summary of the subject rent with a comparison to the market rent survey and including the sale data survey is provided in the Income Approach Addendum.
- The cost approach was completed and reconciled to develop the final opinion of value. The subject property is 8 years old; the ADU was built one year ago from the effective date of the appraisal. The owner of the subject property provided the cost data for the ADU. I also completed an online Marshall & Swift Cost analysis for both the primary dwelling and the ADU. A summary of the data used to produce the cost data applied in the approach is reconciled in the cost addendum. Four improved site sales were analyzed that were in the defined subject's market. A summary of the site sales is provided in the cost addendum along with a reconciliation of the site value used in the cost approach. The depreciation percent applied was based on the modified age-life method. The primary dwelling is eight years old, and the ADU is one year old. The condition of the primary dwelling and ADU are good (see the Improvements section for details); therefore, the applied depreciation percent adjustment for the primary dwelling was 10%; and the ADU was 1%. The depreciation analysis and calculation are included in the cost addendum. A summary of the site value, cost data, and depreciation are provided in the Cost Approach Addendum.
- The cost approach was not completed. The primary dwelling is 79 years old. The ADU is a detached, legal, nonconforming structure at the back of the subject property. It originally was a converted carriage house from the early 1900s. The primary dwelling is in average condition, and the ADU is in below-average condition. Both structures need maintenance and updating to be competitive in the subject's current market.



## Digging Deeper, cont.

### E. cont.

Many condition issues are due to a leaking roof requiring correction (refer to the Improvements and Reconciliation sections for details). The location is urban, and vacant site sales do not exist in this market (beyond tear-down properties which are scarce). Depreciation is at best a guesstimate due to the condition and age of the primary and ADU structures but would be significant. The number of factors necessary to develop a credible cost approach are not available for this appraisal assignment.

- The sales comparison approach was the primary approach to value due to the extensive data available and ability to verify the transactions. Four closed sales were identified in the subject neighborhood, and two had ADUs. Both units were being used by the owner of the property (none were rented), similar to the subject property's ADU. Further, two listings, one with and one without an ADU were also identified and verified. Details regarding the listings are provided in the Sales Comparison Approach section along with the sale transactions. Currently, all the comparables, both sales and listings, are from the subject's market area as defined in the Neighborhood section. The primary dwellings of all the comparable sales are within +/- 5% to 9% range from the subject's primary GLA.

The ADUs for both sales and listings were larger than the subject's ADU by 5% to 8%; however, the interior quality was inferior (see the Improvement description in the Sales Comparison Approach addendum). The condition of all the primary dwellings was the same as the subject's condition – good (see the Improvements section for details). The data regarding the transactions was verified by online photographs and discussion with the real estate agents for the properties. Overall, see the Sales Comparison Approach Addendum for a detailed summary of the transaction data and adjustment analysis applied in the sales comparison grid. The range of adjusted sale prices for the comparable sales is \$345,000 to \$365,000, or a variance of ~6%, and the unadjusted sale prices range is \$334,999 to \$373,500, or a variance of ~12%.

- Here is an overall conclusion of the type and extent of analysis: Each approach to value was considered in the analysis of the subject property. The certification identifies that the primary approach must be considered the sales comparison approach.





## Digging Deeper, cont.

### E. cont.

In the analysis of the subject improvement that includes an ADU, after collecting and verifying data, it was clear that the sales comparison was the most reliable approach to develop the subject's final value opinion. There were ample sales, specifically four closed transactions and two listings. Of this total, three were properties with ADUs like the subject property. The comparison of these transactions to the subject property resulted in a variance of ~6% adjusted and ~12% unadjusted. The cost approach was also considered reliable due to the age of the subject property and the fact that the owner provided the cost to build the ADU, which was only one year old at the effective date. The primary dwelling was only eight years old; and both of the improvements were in good condition (see Improvements section for the details and reasoning for this opinion). There were four comparable site sales in the subject property's defined market that were analyzed and used to develop the site value. The depreciation was based on the modified age-life method and was supportable due to the minimal wear and tear on both improvements and the property overall. However, the income approach lacked rental data and rental sales data for analysis and was not considered a reliable approach to value. The subject property and all the comparable sales with ADUs were not rental properties. Instead, the ADUs were being used for personal use by the property owners. The sales comparison approach value conclusion is \$352,000, and the cost approach value conclusion is \$354,000. Both support the final value conclusion within a half percent; however, the data in the sales comparison approach was the most compelling due to the amount and accuracy of the verifiable data and the fact that all the data was within the subject's defined neighborhood, resulting in a final value opinion of \$352,000.

### F. Conclusion of scope of work

The scope of work is an area often neglected in residential lending work because appraisers rely on the preprinted scope of work. 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. Keeping the intended use, intended user, and type of value in focus when developing the scope of work is significantly important to the credibility of the appraisal and the avoidance of leaving out information or making an error that could cause the appraisal report to mislead the client/intended user. The following statement says it best.



## Digging Deeper, cont.

**Reminder.** The scope of work is a critical step in the appraisal process. The manner in which the appraiser addresses scope work in the report should underscore its importance. In the briefest of appraisal reports, the scope of work discussion might well comprise the bulk of the report.<sup>51</sup>

HERS = Home Energy Rating System, a RESNET energy-efficient rating system for residential properties. The lower the score, the more efficient the structure. The rating measures all the structure components that contribute to the energy efficiency of the structure (insulation, lighting, tightness of the envelope, appliances, mechanical efficiencies, window efficiency, weather stripping, and orientation).

A resource to learn more about energy-efficient properties and ratings can be found in the Appraisal Institute's website under Publication, "Residential Green Valuation Tools."

Appraisers have free access to the RESNET database that gives appraisers more information than the public RESNET database.

To register for the RESNET Appraiser Portal, go to the following website:

<https://portal.resnet.us/>

RESNET has a public database that gives less information than the RESNET Appraiser Portal. It is at the following website:

<https://www.hersindex.com/hers-rated-home-search/>

**End Digging Deeper**

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51. Stephanie Coleman, MAI, SRA, AI-GRS, AI-RRS, *Scope of Work*, Third Edition. (Chicago: Appraisal Institute, 2020), P. 67.



## Learning Objectives

Now that you've completed Part 4, you should be able to

- Recognize MLS data challenges.
- Identify the limitations of public property records.
- Understand the importance of developing an appropriate scope of work.

## Terms and Concepts to Remember

### Data search platforms

HERS	Realtor.com	Zillow.com
MLS	Residential Energy Systems Network (RESNET)	
Public property records		

### Characteristics

Economic characteristics	Legal characteristics	Physical characteristics
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### Definitions

Appraiser's peers	Scope of work
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### Rules

Scope of Work Rule

## Recommended Resources

Stephanie Coleman, MAI, SRA, AI-GRS, AI-RRS, *Scope of Work*, Third Edition (Chicago: Appraisal Institute, 2020).

Uniform Standards of Professional Appraisal Practice (Washington, D.C.: The Appraisal Foundation, 2020-2021 ed.), Advisory Opinion 28, Advisory Opinion 29.



## **Solving ADU Valuation Dilemmas**

Reviewing a variety of dilemmas will be the focus of Part 5. Listing ways to solve the dilemma is a great way to learn how an appraiser's peers would approach the solution. The discussions and suggested solutions are great resources for future appraisal assignments. The dilemmas were taken from interviews of residential appraisers from around the country.

## **Learning Objectives**

To prepare for Part 5, read the following learning objectives and refer back to them as you study this part.

- Identify approaches for valuing ADU properties.
- Solve the dilemmas that reflect typical appraisal challenges.

## **Learning Tips**

During Part 5, the class will discuss solutions to dilemmas along with the application of the approaches to value in developing a final opinion of value as it all applies to a subject property with an ADU. There is not enough time to cover all the dilemmas. The instructor will choose the dilemmas that are most relevant to your market area. Apply to the dilemmas what you have learned about appraisal assignments that include an ADU improvement. This process will clarify areas that you may have found challenging. Participating in the discussion and taking good notes for future assignments will make this last part the highlight of the class.



# Part 5.

## Solving ADU Valuation Dilemmas

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### I. Sales Comparison Approach

A. The sales comparison approach is the most often used approach to value. It is driven by the fact that the certification (in the appraisal report forms) specifically require it.<sup>52</sup> The secondary mortgage market and government entity appraisal guidelines address the sales comparison selection as follows:

1. Dated settled sales may be used to demonstrate market acceptability.
2. Active listings or pending sales may be used as supplemental exhibits to show marketability.
3. At least one ADU comparable sale is required. An appraiser should include a traditional comparable sale with an ADU in the sales comparison grid.

**Note.** If there is a scarcity of current sales, listings, or pending sales to support a market for the subject property with an ADU, another alternative exists: the use of expired listings and withdrawn listings is a possibility, or an appraiser can go even further back in time but stay within the defined subject neighborhood or market area.

B. In the effort to support a statement that a market for ADU properties exists in the subject neighborhood/market area, an appraiser should remember that the dated settled sales, listings, or pending sales do **not** have to be comparable properties to the subject property to show this type of support. 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 to 2,500 square feet with ADUs that vary between 500 and 800 square feet.

1. These sales would **NOT** be placed in the sales comparison grid because they do not represent sales that are “comparable” to the subject property.

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52. Fannie Mae Form 1004. Appraisal Certification. #4. “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.”



2. 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 (at a minimum). This data further answers the underwriter’s question: “Is the ADU a feature that is accepted in the subject’s defined neighborhood and/or market?” The Fannie Mae ADU Update<sup>53</sup> was distributed in August 2020. Therefore, some clients/lenders, reviewers, and underwriters, etc., may be unfamiliar with the document. It would be most helpful and likely a timesaver for the appraiser and those parties if the update documentation is cited or referenced in the appraisal report.

C. Paired-data analysis – Accessory dwelling unit value contribution

The following paired-data analysis table is for educational purposes only and not a market sale. It provides a good example of a pairing to extract the value of a feature from the market.

<b>5.1 Table. Paired-Data Analysis</b>		
	<b>Sale No. 1</b>	<b>Sale No. 2</b>
Sale date	6 months Ago	8 months Ago
Sale price	\$790,000	\$715,000
\$/Sq. Ft.	\$359.09	\$336.47
Lot size	18,000 sq. ft.	22,000 sq. ft.
Single-family dwelling GLA	2,200 sq. ft.	2,125 sq. ft.
Room count	6/3/2.5	6/3/2.5
Basement	No	No
ADU – Size-Age-att/det	Att. 575 sq. ft. – 4 years	None
Adjusted sale price	\$790,000	\$715,000
<b>Difference</b>	<b>\$75,000 (\$790,000-\$715,000)</b>	

53. Fannie Mae Selling Guide, B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020).

The two paired sales 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 GLA of the primary structure is not recognized by the market. A real estate agent interview of the selling agents for both sales report the condition and quality of construction as similar. While the sales are not in the same subdivision, they are in adjacent subdivisions that compete for the same buyer. 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 and built to accommodate an aging parent.

**Note:** 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 pair suggested the ADU had a contributory value of \$150,000, the cost to build four years ago was \$125,000, and today's cost new is \$150,000 – then the appraiser needs to stop and ask – “Does that make sense?” The market is not perfect and renders results that sometimes are not logical. It's important to 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 logic. A test of reasonableness is considered a sensitivity analysis; see the example below. Apply the adjustment from the paired-data analysis to a series of “comparable sales” and see if the adjusted sale prices reflect a reasonable range based on the data collected and verification of sales in the subject market and the market trend analysis conducted.

#### D. Sensitivity analysis

**Sensitivity analysis.** *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 analyses.*<sup>55</sup>

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54. *The Dictionary of Real Estate Appraisal*, 7th ed. (Chicago: Appraisal Institute, 2022).

## 5.2 Table

Sensitivity Analysis to Isolate the Value of an Accessory Dwelling Unit										
Features	Base									
	Comparable 1	Comparable 2		Comparable 3		Comparable 4		Comparable 5		Comparable 6
<b>Price</b>	\$785,000		\$855,000		\$775,000		\$900,000		\$750,000	\$765,000
<b>Contract Date</b>	Current	3 months ago		2 months ago		1 month ago		4 months ago		2 months ago
<b>Condition</b>	Good	Good		Good		Good		Good		Good
<b>Site Size/Sq.Ft.</b>	8,000	9,500		8,700		10,500		7,500		8,000
<b>Gross Living Area</b>	1,750	1,625		1,695		2,100	-26,250	1,525	16,875	1,800
<b>Parking</b>	2-car garage	2-car garage		2-car garage		3-car garage	-10,000	2-car garage		2-car garage
<b>ADU</b>	No	Yes-600 SF	-75,000	No		Yes-575 SF	-75,000	No		No
<b>Basement</b>	None	None		None		None		None		None
<b>Other</b>	None	None		None		None		None		None
<b>Adjusted Sale Price</b>			<b>\$780,000</b>		<b>\$775,000</b>		<b>\$788,750</b>		<b>\$766,875</b>	<b>\$765,000</b>
<b>Variance as a percentage</b>			-0.64		-1.27		0.48		-2.31	-2.54
<b>Average Percentage Variance versus Base Sale</b>						1.26				

Comparable 1 is the base comparable sale, and adjustments are applied to the remaining five 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 during the four months span in market time; therefore, it requires no adjustment for date of sale. The data supports that minor differences in gross living area are not recognized by buyers; therefore, no adjustment is applied for less than 100 square feet in gross living area. The ADU adjustment identified in the previous paired-data analysis is applied to Comparable Sales 2 and 4. After applying the \$75,000 adjustment for the ADU on those two sales, the results show that the two sales are in a tight range of the base sale. The overall average variance of - 1.26% is insignificant, which lends good secondary support to the ADU adjustment of \$75,000.

## 5.3 Discussion Questions

An appraiser used a paired-data set to establish an ADU value and converted it to a percentage of the sale price. Using the previous paired-data set as an example, ( $\$75,000/\$790,000= 9.5\%$ ), this percentage adjustment is used as an ADU adjustment in the sales comparison approach for future appraisal assignments. Is it an acceptable practice to convert the ADU dollar adjustment to a percentage for use in all similar ADU appraisal problems? Why or why not?



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## 5.3 Discussion Questions, cont.

For example, review the use of a percentage adjustment below as applied to a variety of sale prices and see how wide the adjustment becomes. Apply logic and answer the question, “Does it make sense?”

Comparable #	Percentage	Sale Price	ADU Value	ADU Sq. Ft.	ADU \$/Sq. Ft.
1.	9.5%	\$1,675,000	\$159,125	700	\$227.23
2.	9.5%	\$575,000	\$54,625	475	\$115.00
3.	9.5%	\$250,000	\$23,750	400	\$59.38

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## II. Income Capitalization Approach

- A. Single-unit properties are appraised using the income capitalization approach by
1. Analyzing market rents to establish the potential market rent for the subject property
  2. 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*

- B. 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 property with the rental data collected from another property also similar to the subject property. 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).

**Warning.** Extreme caution is necessary when choosing to use a market-extracted *GRM* multiplied by a marketed-extracted rental rate and applying it to the ADU of the subject property or comparable sale to develop an opinion of value for the ADU.

1. A *GRM* includes rent attributed to the land and the improvements.
  2. 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.
  3. 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.
  4. It is possible to extract the land value from the *GRMs*; however, it complicates the appraisal assignment and requires extensive support and explanation for the client/lender to understand. It is not a typical method buyers seeking one-unit dwellings with ADUs will use to determine the worth of the ADU to them.
  5. Finding similar single-unit sales with ADUs where both primary dwelling and ADU are rented would be ideal, but those rarely exist in sufficient supply to provide a credible value opinion.
- C. 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.

## 5.4 Example

### **Income Capitalization Approach: GRM Applied to the Accessory Dwelling Unit Rental**

This 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. **Note.** If the subject property is rented, it does not indicate an income capitalization approach is applicable if it is the only house in the neighborhood that is rented.

The primary dwelling unit is rented at \$3,500 per month, and the ADU is rented at \$1,500 per month. Both have yearly 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 that are 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 comparable sales. 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 *GRM* supports 130.

*GRM Reconciliation.* The sales form a reasonable range of *GRMs*. 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 property's neighborhood and most similar in condition and updates, supporting a *GRM* of 130.

Application of the formula –  $GRM \times \text{Monthly rent} = \text{Value indication}$

$\$3,500 + \$1,500 \text{ monthly rent } (\$5,000) \times 130 = \$650,000 \text{ indicated value by the income capitalization approach}$

## 5.5 Example

### Payback Period

Another way market rent can be valuable is by establishing a period in which it would be reasonable to recoup the investment of \$75,000, 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/month. How long will it take for the owner to receive \$75,000 back in rent collected, assuming there are no annual rent increases or decreases (in the case of a vacancy in an up or down market)?

$\$75,000 \text{ contributory value} / \$1,500 \text{ monthly rent}$  suggests the payback period is 50 months / 12 months = 4.17 years.

However, that is not the whole story: The formula above does not account for primary tenancy, real estate taxes, and insurance, and it does not consider rent increases or decreases. These additional expenses and potential rent changes may not extend the payback period significantly unless market changes are dramatic. For example, a massive flood, tornado, hurricane, or earthquake could instantly change the rental market as well as a major employer relocating from an area or a significant change in the interests, etc. It is reasonable to discuss the payback period to support the indicated value by the paired-data analysis method.

In this example, the investors who pay \$75,000 for the subject's property's ADU are anticipated to receive the payback of their investment (gross rent) in a little over four years (i.e., 4.17 years).

A quick payback period like this one is extremely attractive for real estate investors. Even an owner-occupant would agree that this would 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 carryback loan.

### III. Cost Approach

A. 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 particular requirements that can materially affect cost. For instance, a few items and questions that may materially impact the cost new are listed below and at the top of the next page.

1. Detached units cost more to construct than attached units.
2. How much is the building permit?

3. Is the ADU subject to impact fees?
  4. Do additions to an ADU require approval from a Review Committee?<sup>55</sup>
  5. ADUs cost more per square foot to build than the primary dwelling based on the principle of the economies of scale<sup>56</sup> (i.e., the smaller the space, the more expensive the cost).
  6. Does the ADU have specific building ordinances that must be met, like parking requirements, setbacks, height restrictions, etc.?
- B. Once the cost new is established, the next most difficult step is supporting the depreciation, including potential obsolescence from all forms of loss.
1. This step is challenging, but it must be based on market data and be objective and avoid being subjective.
  2. Some appraisers might overlook that even a proposed or new construction improvement should be analyzed for obsolescence. Developers will and can use dated floor plans for fast and cheaper construction and greater profit, yet those floor plans are outdated and may be the reason sales are slow in that subdivision.
    - a. The terms *proposed* or *new* do not eliminate the concept of functional obsolescence.
    - b. Proving this step with good market evidence requires sale data of similar units to understand how the cost new relates to the contributory value of the ADU.

**Depreciation.** *In appraisal, a loss in the value of improvements from any cause; the difference between the cost of an improvement on the effective date of the appraisal and the value of the improvement on the same date.*

**Contributory value.** *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.*

**Source:** *The Dictionary of Real Estate Appraisal, 7<sup>th</sup> ed.* (Chicago: Appraisal Institute, 2022).

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55. Development Review Committee. A development review committee 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.
56. **Economies of scale.** *Reduction in cost of production per unit due to a large number of items produced.* Source: *The Dictionary of Real Estate Appraisal, 7<sup>th</sup> ed.* (Chicago: Appraisal Institute, 2022).



3. 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.
4. The Fannie Mae guidelines do not allow the cost approach to be used as the primary or only basis for an opinion of value.<sup>57</sup> While the cost of things like repairs, updating, remodeling, etc., is a method buyers and sellers in the market commonly consider when negotiating a home, the cost approach does have weaknesses, and in some markets, the weaknesses may not outweigh those of the other approaches.
  - a. An experienced appraiser will discuss the strengths and weaknesses of each approach as the approaches apply to the particular appraisal problem they are solving.
  - b. 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.

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57. *Fannie Mae Selling Guide*. Part B: Origination Through Closing, Washington, D.C. Fannie Mae, 2/31/2021, P. 585.

## Cost Approach to Value

“Fannie Mae does not require the cost approach to value except for the valuation of manufactured homes. However, USPAP requires the appraiser to develop and report the result of any approach to value that is necessary for credible assignment results. For example, when appraising proposed or newly constructed properties, if the appraiser believes the cost approach is necessary for credible assignment results, then the cost approach must be provided. Appraisals that rely solely on the cost approach as an indicator of market value are not acceptable.

The cost approach to value assumes that a potential purchaser will consider building a substitute residence that has the same use as the property being appraised. This approach, then, measures value as a cost of production. It may be appropriate to use the cost approach when appraising new or proposed construction, property that is undergoing renovation, unique property, or property that features functional depreciation, to support the sales comparison approach analysis. The reliability of the cost approach depends on valid reproduction cost estimates, proper depreciation estimates, and accurate site values.

If the appraiser has completed the cost approach, the lender must thoroughly review the information provided to confirm that the appraiser’s analysis and comments for the cost approach to value are consistent with comments and adjustments mentioned elsewhere in the appraisal report. For example, if the neighborhood or site description reveals that the property backs up to a shopping center, lenders should expect to see an amount indicated for external depreciation in the cost approach.

Or, if the improvement analysis indicates that it is necessary to go through one bedroom to get to another bedroom, lenders should expect to see an amount indicated for functional depreciation.”

**Source:** Fannie Mae Selling Guide, dated 2/03/2021  
Part B, Origination Through Closing  
Subpart B4, Underwriting Property  
Chapter B4-1, Appraisal Requirements  
Section B4-1.3-10, Cost and Income Approach to Value

### STANDARDS RULE 1-1, GENERAL DEVELOPMENT REQUIREMENTS

“In developing a real property appraisal, an appraiser must:

- (a) be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal.” (USPAP, 2020-2021)

- C. Fannie Mae allows the appraiser to fulfill USPAP requirements and remaining sales within the appraisal guidelines. The assignment conditions when using an agency appraisal report form, per Certification 4, do **not** allow the cost approach to be the only approach or the sole basis for the value opinion.
  
- D. Appraisers must have a “can do or customer friendly” attitude. Instead of looking for reasons not to comply, appraisers should understand and apply Standards<sup>58</sup> and state laws along with the client’s and applicable agencies’ appraisal guidelines/requirements known as assignment conditions. They should discuss such assignment conditions with the client to help the client make the best decision for the intended use of the appraisal and keep the appraisal assignment in compliance without creating further liability. The right attitude and a discussion centered on the following question set the atmosphere of professionalism and mutual respect with the client: “How can we meet your needs and follow all applicable assignment conditions?”

#### **IV. Dilemmas**

The following dilemmas provide practice in solving typical appraisal challenges related to ADUs.

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58. Standards of Valuation Practice (SVP) apply to Designated members of the Appraisal Institute as well as Candidates for Designation, Practicing Affiliates, and Affiliates. USPAP Standards apply to all federally related transactions.

## 5.6 Dilemma



### Limited Parking

The owner of the property applied for a refinance loan with a local lender. The lender hired an appraiser to complete the appraisal report for the loan. The following is a description of what the appraiser identified at the time of inspection as part of the appraisal assignment.

The subject property is a small house with a short, single-car driveway that leads to a detached, two-car garage with an ADU above the garage that is about 10 yards from the small house at the front of the lot. Both housing units are rented to independent third parties. The neighborhood is pricey, and there is demand for housing units. The renters have to interact with each other since the parking arrangements are not adequate. This entails moving cars to allow one of the tenants to exit the property because off-street parking is not allowed. *What are the initial thoughts of the appraiser? What do the lender's appraisal requirements and applicable agency guidelines or requirements state about one-unit properties with an ADU rental? What questions might the owner/borrower expect the appraiser to answer in this dilemma? What additional facts might the appraiser need to determine about the potential ADU tenant?*

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**5.6 Dilemma, cont.**



**Limited Parking, cont.**

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**5.6 Dilemma, cont.**



**Limited Parking, cont.**

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## 5.7 Dilemma



### Lenders Advise Value of ADU

This dilemma is based on an interview with an appraiser about ADUs in his market in which the following was reported.

Lenders told the appraiser that ADUs are not appraised as additional square footage. ADUs are appraised as an amenity, like a swimming pool or garage, and placed on one of the open lines in the sales comparison grid. Further, appraisal reports that have been reviewed by these lenders where an ADU is present have been adjusted at \$50,000. However, there is no support provided for this adjustment in the sales comparison approach.

The appraiser gave the lender the following points regarding his view of an ADU's value:

1. My view is from the buyer's perspective.
2. ADUs do NOT carry the same price per square foot as the primary house.
3. Research shows buyers of a two-bedroom, one-bath primary house with an ADU are willing to pay more than for a similar house without an ADU. The ADU has contributory value.
4. However, data shows that a two-bedroom, one-bath primary house with an ADU sells for the same as a three-bedroom, two-bath primary house with no ADU. This suggests the ADU takes the place of the third bedroom and second bathroom.
5. The value of ADUs is limited in the market and the best comparison is the two-bedroom, one-bath primary house with an ADU compared to a three-bedroom, two-bath primary house without an ADU.

The lender asked the appraiser what their conclusion is based on these comments.

The appraiser responded, "The resale value of the ADU is not coming from the sale of the property. If the ADU can be rented legally, then the appraiser must analyze the rental income and expenses to determine if a great return can come from the rental status."

1. *Are the opinions from the lenders appropriate and relevant? Explain.*





## 5.7 Dilemma, cont.



### Lenders Advise Value of ADU, cont.

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60. USPAP, STANDARDS RULE 1-4 Intro and 1-4(a): “In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results  
(a) When a sales comparison approach is necessary for credible assignment results, an appraiser must analyze such comparable sales data as are available to indicate a value conclusion.” (USPAP, 2020-2021 ed.)

**5.7 Dilemma, cont.**



**Lenders Advise Value of ADU, cont.**

2. *How does considering an ADU's rental income and not resale value address the financial feasibility?*

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## 5.8 Dilemma



### Basement Units With a Valid Business License

Paired-data analysis in a metropolitan city of two identical basement apartments in an adjacent row house may be valued differently due to the legal status of the permitted uses.

For example, R-4 zoned basement rental apartments are permitted provided the following:

- Both permitted dwellings are at least 900 square feet. (Anything less than 1,800 square feet total only allows for one unit.)
- A business license and certificate of occupancy can only be obtained if the property has 1,800 square foot minimum lot size. If no license or certificate, no value can be attributed.
- Contributory value for a basement apartment ADU with a valid business license and certificate of occupancy ranges between \$25,000 and \$35,000.

1. *Is the value difference for the ADU, or is it for the legal status (business license and certificate of occupancy)?*

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**5.8 Dilemma, cont.**



**Basement Units With a Valid Business License, cont.**

2. *List the steps to address value in the row house without a business license or certificate of occupancy.*

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## 5.9 Dilemma



### Basement Apartment Without a Valid Business License

Properties with finished basement apartments often rent to nonrelated parties whether or not they have a valid business license and certificate of occupancy for independent rental use. In this case, the appraiser does not assign any value to the apartment.

*Should the value be zero if the apartment is not properly licensed and a certificate of occupancy obtained? Explain.*

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**5.9 Dilemma, cont.**



**Basement Apartment Without a Valid Business License. cont.**

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## 5.10 Dilemma



### **A Legally Permissible ADU Requires Registering the Improvement**

A residential appraiser provided the following comments about his experience with ADUs.

“The first step is always to analyze the highest and best use. An initial step is to determine if the subject is legally permissible. This requires an understanding of the subject’s community and its master plan along with the subject’s zoning. Is the use a single-unit with an ADU, or is it a multifamily dwelling? In this dilemma, the zoning authority requires registration. There is no zoning classification for an ADU that was illegally constructed. Instead, the key issue comes down to is an improvement like an ADU registered?”

1. *Assuming a property with an ADU is legal but has not been registered, what steps would you follow to provide an as is value?*

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In this market area, if the ADU is not in compliance with zoning, a survey of the vicinity should be done to identify other properties that are also noncompliant with zoning. This is similar to the agencies’ requirements to show market acceptance. If the survey shows this is accepted in the market area, the zoning department classifies the property as “legal nonconforming,” and the appraiser would then explain and show it as legal with full disclosure of what makes it legal.

## 5.10 Dilemma, cont.



### A Legally Permissible ADU Requires Registering the Improvement, cont.

2. *What are the steps the appraiser should take when the property does not conform to zoning regulations?*

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## 5.10 Dilemma, cont.



### A Legally Permissible ADU Requires Registering the Improvement, cont.

“I further add a disclosure statement on Page 1 of the appraisal report form and anywhere else in the report where the value opinion is stated. The disclosure statement is: Per the lender, this loan may not qualify to be sold, insured, or guaranteed by private or public entities due to the legal issues associated with the subject property and the assignment condition requested by the lender/client in developing the opinion of value.”

**Reminder.** For lending assignments, *all* agency appraisal guidelines or requirements mandate the appraisal be completed in compliance with USPAP; no such guidelines or requirements are in noncompliance with USPAP because they either meet the standards or surpass the standards.

3. *What kind of assignment conditions might not be in compliance with USPAP or the appraisal guidelines or requirements of agencies like Fannie Mae, Freddie Mac, FHA, and VA?*

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## 5.11 Dilemma



### Setbacks: Legal, Illegal, or Legal Nonconforming

- Some lenders require any property that does not comply with setback requirements to be deemed “illegal” in the zoning classification.
- The problem: This is not true of all lenders. Some state it is a matter of lender/risk tolerance or regulatory requirements by their auditors.
- In this market, the correct step would be for the owner to register the construction in addition to the original structure. (It’s not uncommon for structures in this market to be built without permits, due to owners wanting to avoid paying for permitting and insurance.)
- Owners interviewed about constructing an ADU without a permit report the permitting process takes too long because there are not enough agents to verify the construction promptly.
- These unpermitted structures can go unnoticed by code enforcement until a neighbor calls and complains, or it may happen when the property is listed for sale.
- After the appraisal, a lender will often cancel the assignment once the lack of permit is discovered.
- Lenders commonly require one comparable sale with an illegal ADU. If a recent comparable sale with the same nonpermitted use is not available, other evidence may be acceptable. (Dated sales, listings, expired, rented, etc.)
- One sale in the sales comparison approach does not support evidence that illegally zoned properties are common in the market. Appraisers must show enough properties that support the conclusion.

**Reminder.** The appraisal guidelines discussed in Part 3 note that Fannie Mae and Freddie Mac will purchase mortgages with illegal zoning if specific guidelines, including the appraisal requirements, are met. The VA has specific requirements if the subject property does not comply with current zoning for the subject, but the local authority accepts the subject property as is (see the VA requirements on the next page).

## 5.11 Dilemma, cont.



For an Appraisal Report, USPAP requires the support and opinions developed to be summarized in the report. In this dilemma, it is clear the zoning authorities do not accept this illegal use, and this fact should be clear and unambiguous in the reporting of the subject property’s zoning status and in the highest and best use analysis to avoid being misleading. The following is an example of VA appraisal requirements and zoning compliance:

**Zoning Compliance:** “The property must comply with all applicable zoning ordinances.”

**Legal, Non-Conforming Use:** “If the property does not comply with current zoning ordinances, *but is accepted by the local authority*, the appraiser must describe the property as ‘Legal Non-Conforming’ and comment on the property’s marketability and any adverse effect this classification may have on value. The appraiser must state whether or not the dwelling may be legally rebuilt if destroyed.” [Italics added for emphasis.]

**Source:** VA Pamphlet 26-7, Chapter 12, Topic 12b, Dated 3/28/2019, P. 12-17.

*What can you draw from this scenario regarding the setbacks and legal status?*

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## 5.12 Dilemma



### A Veterans Administration Case – From a Reviewer’s Perspective

The following reviewer observations were made about the appraisals of properties with ADUs for VA lending.

**Note:** The first observation is the most confusing for appraisers and often leads them to incorrect assumptions or valuation conclusions. *Do not make incorrect assumptions based on confusing statements.* Instead, when confronted with unclear issues in the VA appraisal requirements, contact the lender/client and the VA. Do not continue with the assignment until direction has been given by the lender/client and VA. Once again, be sure any direction or request is in compliance with USPAP, at a minimum. The appraiser is responsible for understanding the VA appraisal requirements to ensure the appraisal and the reporting are in compliance.

**Chapter 6 of the VA Guide Item 6b** states – “As part of the highest and best use analysis, the appraiser must determine if the property is a single-family dwelling with an ADU, or a two-family dwelling. The highest and best use must be a legal use (see Topic 10). A two-family dwelling must be appraised on the Fannie Mae Form 1025, *Small Residential Income Property Appraisal Report*.”

The following are additional observations made by VA reviewers about the appraisal reports they reviewed for VA lending of properties with ADUs.

- a. **Rationalizing without evidence.** Rationalizing that the property is a duplex and then stating the zoning is illegal. The basis for this inaccurate action and conclusion is the identification of how many utility meters the subject improvement has and if the primary dwelling and ADU are rented.
- b. **Misunderstanding.** Not understanding that the appraisal assignment is **not** to answer the following question with a simple Yes or No answer: “If the buyer/borrower/veteran purchased the subject property that has an ADU, does the ADU have market value?” A more lengthy explanation than yes or no is needed.
- c. **Does it have value?** If zoning specifically does not allow for an ADU, and the subject property has an ADU, disclose the findings. However, the question that needs to be answered is, “Does the illegally-zoned ADU have value in the subject property’s defined market area?” The VA does not expect an appraiser to act as the code enforcement police. However, the VA does need factual information and supported opinions and conclusions regarding zoning factors.

## 5.12 Dilemma, cont.



### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

- d. **Unsupported marketing conclusions.** The appraisal report identifies the ADU and states, “The improvement lacks marketability in the subject’s defined neighborhood.” However, no research or analysis is provided in the appraisal report to support this opinion. At the same time, data collected on the marketing of the subject property identifies it was under contract in 10 days (DOM). Further, the comparable sales with ADUs used in the sales comparison grid sold in under 30 days and were under contract within 15 days, similar to the subject property. This gives the appearance of incompetency or lack of due diligence in completing the assignment.
- e. **Unable to bracket.** An appraisal report states, “No sales exist with an ADU, so I was not able to bracket the property features. Therefore, it has no value.” When the appraiser was questioned, he said he limited the search to six months and did not consider competing neighborhoods or markets. Also, the appraiser stated, “Only sales were considered; listings and pending sales were not.” This gives the appearance of incompetency or lack of due diligence in completing the assignment.

1. *Why are the number of meters and rental status not representative of the classification as a duplex?*

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2. *Item d above addresses marketability weaknesses. How might the marketability be supported?*

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## 5.12 Dilemma, cont.

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### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

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## 5.12 Dilemma, cont.



### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

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**Reminder:** A “No sale – No value” has never been a recognized appraisal theory and has never been a recognized appraisal method or technique. Further, USPAP requires appraisers have support for their opinions and conclusions. This includes conclusions of “no value” because “none” or “\$0” is a conclusion.

### 5.13 Dilemma



#### ADU Without a Bathroom

An appraisal assignment notes the property is a single-unit house with an ADU. Upon inspection of the property, the appraiser finds the property is a single-unit house with an ADU that is an attached garage conversion with a separate entrance. However, the ADU does not have a bathroom.

- 1. Does the lack of a bathroom affect the ability to appraise the property as a single-unit house with an attached ADU? Explain.

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### 5.13 Dilemma, cont.

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#### ADU Without a Bathroom, cont.

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## 5.14 Dilemma



### Rural Property With ADU Rental

The MLS listing for the subject property identifies its location as rural and with an ADU that is registered as an Airbnb rental. The MLS listing also states: “This property is occupied, and the sellers have two small children. If possible, notify agent the day before viewing to make arrangements. The breezeway connects two homes. Seller needs to request permission to show the cottage because it is occupied commonly with short-term renters.

There are five-bds total but only a 3-bd septic field. Enjoy privacy and serenity at this 23-acre farmette surrounded by open farmland. Enjoy views of the Blue Ridge Mountains from various areas of the property and the driveway.

The well cared for 3-bd, single-level home & the 2-bd guest cottage with a kitchen and bath are well positioned in the middle of the property. The guest cottage (separated by a breezeway) is currently being used year round as an Airbnb rental. This rental has received ‘Superhost’ status from Airbnb with over 100 five-star reviews. It generates an average of \$20,000 in gross profit annually. Guests enjoy the relaxing farm atmosphere and rolling hills. This cottage could also serve as an in-law suite or additional living space for guests.

A small pole barn with a one-horse stall sits inside a secluded fenced-in paddock and has electric service and a frost-free well spigot. There is a small pond and dock on the property as well.”

1. Does this “guest cottage” meet the ADU criteria?

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## 5.14 Dilemma



### Rural Property With ADU Rental, cont.

2. Is this property eligible for a Fannie Mae/Freddie Mac mortgage? Explain.

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3. What challenges might you expect in developing an appraisal on this property?

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4. Assume the appraisal is **NOT** for mortgage lending purposes. Will the \$20,000 gross rent be useful in developing a value of the “guest suite?”

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## 5.15 Dilemma



### FHA Loan and Appraisal on a Property With an ADU

A lender ordered an FHA appraisal on a property with a second unit identified on the appraisal engagement form as an ADU. The lender concluded it was a single-unit property with an ADU because the MLS listing that the lender obtained marketed it as such.

The appraiser verified the zoning as “RES” or Residential Low-Density District, allowing single-unit only. The appraiser determined this two-unit property does not meet zoning because it is a multifamily (duplex) property that is located in a residential low-density zoning district. In the Appraisal Report, the highest and best use summary identifies the zoning and the rent for the ADU, and it states that these factors further support the subject property is a duplex property. Also, the appraiser noted two electric and two gas meters. At present, the property is a pending sale at full list price with no seller concessions. The property was under contract in 10 days from original list date. However, the appraiser was not able to research and analyze other sales similar to the subject property to bracket the property features. The appraiser believes this means that the ADU rental does not have market appeal; therefore, no ADU value is attributed because it is not legally conforming.

*Do you agree with the appraiser’s conclusion that this is a duplex? Explain.*

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**5.15 Dilemma, cont,**



**FHA Loan and Appraisal on a Property With an ADU, cont.**

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## 5.16 Dilemma



### Historical District Listing



An MLS listing in the historical district of a small city gives a description of the subject property and includes comments about ADU potential as follows:

“Location, location, location and a 1901 gem! One block from the park and waterfront in this sweet downtown historical district. It is walkable or bikeable wherever you’d like to go to enjoy this tropical paradise. All original plank floors, light and bright. The zoning is neighborhood density of 10 units per acre. Check with local authorities to consider possibilities for the outbuilding – easily converted to a garage, studio/gallery, an apartment – whatever your imagination can conjure up! Outbuilding (480 square feet) is currently being used as storage.”

*What steps would you take to form a highest and best use conclusion as improved if this was your appraisal assignment?*

**5.16 Dilemma, cont.**



**Historical District Listing, cont.**

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## 5.17 Dilemma



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan**

The appraiser completed the property inspection and market analysis, which suggests that 40% of the properties are rented in this market area. The subject property ADU is rented with a yearly lease that has 10 months remaining on the lease. The appraiser informs the client that an income capitalization approach is applicable; therefore, he must expand the scope of work and increase the appraisal fee. The client advises the appraiser that the ADU rental income cannot be used in qualifying the borrower for the mortgage loan, and the client does not need an income capitalization approach.

*What should the appraiser do?*

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## 5.17 Dilemma, cont.



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.**

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## 5.17 Dilemma, cont.



### Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.

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**5.17 Dilemma, cont.**



**Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.**

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## USPAP Frequently Asked Questions That Apply to 5.16 Dilemma

### “FAQ 165. RESPONSIBILITY FOR THE SCOPE OF WORK DECISION

#### **Question: Who determines the scope of work?**

**Response:** It is the appraiser’s responsibility to determine and perform the appropriate scope of work.”

### “FAQ 166. CLIENT SPECIFIES SCOPE OF WORK

#### **Question: Is a scope of work specified by the client acceptable?**

**Response:** The scope of work specified by the client is acceptable only if it allows the appraiser to develop credible assignment results. If the scope of work specified by the client does not permit development of credible assignment results, the appraiser must either change the scope of work to what he or she determines is necessary to develop credible assignment results or withdraw from the assignment.”

### “FAQ 175. JUDGING THE ACTIONS OF AN APPRAISER’S PEERS

**Question: In the SCOPE OF WORK RULE, one of the two tests regarding the acceptability of an appraiser’s scope of work is what the appraiser’s peers would do. There are many appraisers that do things differently, so how would I know what they would do in an assignment?**

**Response:** The SCOPE OF WORK RULE states that the acceptability of an appraiser’s work is judged based on two tests:

- *the expectations of parties who are regularly intended users for similar assignments; and*
- *what an appraiser’s peers’ actions would be in performing the same or a similar assignment.*

The first step in knowing what your peers would do is to identify your peers. In USPAP, the term appraiser’s peers have a specific meaning. It is defined as: *other appraisers who have expertise and competency in a similar type of assignment.*

This definition illustrates that an appraiser’s peers are assignment specific and may change from assignment to assignment. This is because appraisers have varying levels of expertise and competency in specific property types, geographic locations, or other important areas of appraisal. For more information on appraiser’s peers, please see Advisory Opinion 29, *An Acceptable Scope of Work.*

Knowledge about what an appraiser’s peers would do in a similar assignment comes through being a participant in the profession. Typical forums that allow appraisal professionals to share information about practice include appraisal journals and publications, professional meetings and conferences, education through courses and seminars, and appraisal discussion groups.” (USPAP, FAQs, 2020-2021 ed.)

## 5.18 Dilemma



### **Subject Property Has Illegal – Nonpermitted – ADU**

The subject property has an ADU that is not legal according to zoning and is not properly permitted. It is under contract, and the appraisal is for a Fannie Mae backed mortgage. Once the appraiser discovered this issue, she contacted the client/lender and discussed the best method to proceed, but the client's answer seems to be noncompliant to the Fannie Mae appraisal guidelines. The client/lender wants the appraiser to consider the zoning for the subject property and the ADU as though they are legal with no accounting in the sales comparison approach for the fact that they are not legal.

The dilemma is that current sales of similar properties with illegal improvements with ADUs are available. The client/lender says, "If Fannie Mae says illegal improvements are eligible for purchase by the agency, it makes sense to just treat these property issues as though they are legal."

*How should the appraiser proceed with this assignment?*

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## 5.18 Dilemma, cont.



**Subject Property Has Illegal – Nonpermitted – ADU, cont.**

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**5.18 Dilemma, cont.**



**Subject Property Has Illegal – Nonpermitted – ADU, cont.**

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## Digging Deeper

### Excluding an Approach or Approaches

#### “FAQ 313. EXPLAINING THE EXCLUSION OF APPROACHES

**Question:** Standards Rules 2-2(a)(x)(2) and 2-2(b)(xii)(2) and other reporting standards require that I state the reasons for excluding the sales comparison, cost, or income approach(es) if any have not been developed. *In this context, what does “state the reasons” mean?*

If, for example, the cost approach is not developed:

- Is it sufficient to state that the cost approach was considered, but not developed?
- Is it sufficient to state that the appraiser does not consider the cost approach necessary for credible results, thus it has not been developed? If not, what should the appraiser do to comply with USPAP?

**Response:** Simply stating that an approach was not developed does not meet the USPAP requirement to explain why it was not developed.

Stating that an approach was not necessary, without providing some basis for that opinion, also fails to meet the requirement. The report must give some explanation of why an excluded approach is not necessary for credible results.

The USPAP requirement to state the reasons for the exclusion of an approach to value from the analysis is necessary to provide the client and other intended users with insight into why the analysis was not performed.” (USPAP, FAQs, 2020-2021 ed.)

The word *explained* is not a defined term in USPAP and therefore has no special meaning. *Merriam-Webster* defines *explain* as “to give the reason for or cause of.”

## End Digging Deeper

### Solving ADU Valuation Dilemmas

After discussing a number or all of the dilemmas, you should have valuable insight and recognize potential steps to solve ADU appraisal assignments in your market.





## Learning Objectives

Now that you've completed Part 5, you should be able to

- Identify approaches for valuing ADU properties.
- Solve the dilemmas that reflect typical appraisal challenges.

## Terms and Concepts to Remember

Contributory value

Depreciation

## Recommended Resources

Mark R. Ratterman, MAI, SRA, *Residential Property Appraisal*

## Fannie Mae References

In December 2020, Fannie Mae issued an update entitled “Periodic Updates for Residential Appraisers Serving Fannie Mae Customers,” which can be found at the following website address:

[www.singlefamily.fanniemae.com/media/24556/display](http://www.singlefamily.fanniemae.com/media/24556/display)

Page 5 of the update addresses ADUs and is entitled “Accessory Dwelling Unit Updates in the Selling Guide.”

## Additional Resources

AARP – *The ABCs of ADUs*

AARP Accessory Dwelling Units Model State Act and Local Ordinance: <https://www.aarp.org/content/dam/aarp/livable-communities/housing/2021/AARP%20ADU%20Model%20State%20Act%20and%20Local%20Ordinance-0212021.pdf>

AARP – ADU URL: <https://www.aarp.org/livable-communities/housing/info-2019/accessory-dwelling-units-adus.html> – lots of information

AARP – ADU URL: <https://www.aarp.org/content/dam/aarp/livable-communities/livable-documents/documents-2019/ADU-guide-web-singles-071619.pdf>

American Planning Association: <https://www.planning.org/knowledgebase/accessorydwellings/>

Atlanta, GA: Ryan Taylor Architects, LLC had a spring series in 2020 focused on accessory dwelling units. <https://www.gotostage.com/channel/ryantaylorarch>

California Department of Housing and Community Development – Accessory Dwelling Unit Handbook – Effective 2021 – <https://www.hcd.ca.gov/policy-research/accessorydwellingunits.shtml#booklet>

Chicago, IL. ADU ordinance with new requirements and training offered on building code and ordinance, <https://www.chicago.gov/city/en/depts/doh/provdrs/homeowners/svcs/adu-ordinance.html>

Washington, D.C. – Alley Units – <https://www.hillrag.com/2018/03/08/capitol-hill-alley-dwellings/>

Washington, D.C. – Coalition for Smarter Growth – DC Accessory Apartments Forum – [www.smartergrowth.net/adu-forum](http://www.smartergrowth.net/adu-forum)

## **USPAP References**

**ADVISORY OPINION 22, Scope of Work in Market Value Appraisal Assignments for Real Property**

**ADVISORY OPINION 23, Identifying the Relevant Characteristics of the Subject Property of a Real Property Appraisal Assignment)**

**ADVISORY OPINION 28, Scope of Work Decision, Performance, and Disclosure**

**ADVISORY OPINION 29, An Acceptable Scope of Work**

**USPAP FAQ 104** – Workfile Requirements When Communicating Assignment Results (New)

**USPAP FAQ 163** – What is Scope of Work?

**USPAP FAQ 166.** Client Specifies Scope of Work

**USPAP FAQ 177** – Market Rent Opinion

All references are from USPAP, 2020-2021 edition.



**V. Profiles for an ADU**

A. Buyer profile

1. Buyer with aging parents
2. Buyer with adult children unable to afford rental or home purchase
3. Buyer needing additional income\*
4. *Buyer seeking privacy that commonly entertains overnight guests*  
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5. *Buyer looking for a home office*  
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6. *Buyer needing a caregiver*  
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B. Renter profile

1. Student
2. Short-term rental
3. *Single adult*  
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## 1.5 Discussion Question

Identify the material we covered that applies to the highest and best use.



Consider the material covered so far. In order for the appraisal to be compliant and credible, list the topics that should be covered in the four highest and best use tests as improved for an appraisal of an ADU property. (Keep adding to the list as we move through the material.)

### 1. Legally permissible

Zoning district and land use – what is legally permitted?

*Lot restrictions*

*Improvement size restrictions*

*Does state or municipal legislation supersede the local zoning regarding ADUs?*

*Restrictions for parking*

### 2. Physically possible

*Does the current improvement meet the legally permissible test?*

*A review of the attached ADUs versus detached ADUs assists in the test as vacant.*

### 3. Financially feasible

*Address the ADU trends for acceptance or resistance of ADUs:*

- *Housing shortage*
- *Low-income housing needs*
- *Answer to address the homeless*
- *Generational housing needs*

## 1.5 Discussion Question, cont.

- *Provides purchasing power for some homeowners/buyers*
- *An answer to the rising cost of new construction/limited land*

*Describe the character of the neighborhood and existing ADU properties.*

### 4. Maximally productive

*The 1.4 Table, which identified the pros and cons of attached ADUs versus detached ADUs, assists in comparing the existing improvement to the ideal improvement within a market based on the prior three highest and best use test results. The difference between the ideal and existing improvement may reveal obsolescence, additional costs.*

*Potential buyer or renter profile assists in identifying the comparable properties that would compete for a similar buyer or renter.*





**2.1 Discussion Question**

When the secondary mortgage market does not acknowledge the space as an ADU, but the zoning ordinance does allow the ADU space as improved, how should an appraiser proceed without being misleading?



*The appraiser must clearly explain the secondary mortgage market guidelines and the local master plan and zoning ordinance for the subject site to identify the differences for the client. This includes a discussion of how the current market and anticipated master plan for the subject property's neighborhood/market accept the subject property because this research and analysis is part of the financially feasible and maximally productive discussion in the highest and best use.*

- More specifically, ask does the market consider the ADU space part of the gross living area?*
- Or is the ADU space typically used as an income-generating housing unit rented to nonrelatives or friends? Or more commonly, is it a non-rental property occupied by family?*

*This level of research and analysis must be presented in the appraisal report to be useful to the client and avoid being misleading. To cover this topic effectively, understanding the buyer's or renter's profile may require surveying real estate agents involved in the sale/lease and marketing of residential property in the subject property's neighborhood/market.*

## 2.2 Problem



### Zoning: Is This an ADU?

Read through the description below and the zoning excerpts on the next two pages. Then answer the questions that follow.

A house is offered for sale and described as follows: Move-in ready, updated primary house plus additional living quarters on over a 0.5-acre corner lot in a subdivision zoned RSF 5, Residential Single Family, allowing 5 units per acre. Separate utilities and new central air were installed in 2019. The primary residence features 3 bedrooms, 3 baths, living room, and family room. The additional living unit has 2 bedrooms, 1 bathroom, and an open living area. Both residences are updated with a freshly painted interior and exterior, neutral décor, new tile flooring throughout, remodeled kitchen with raised panel cabinetry, solid surface counters, and tile backsplash plus baths with new tile, vanities, and lighting. The additional living unit includes a patio area for outdoor entertaining. The property has a circular driveway with space to park an RV plus room for a pool. The property has a private well and septic.



The aerial was taken from the County GIS Mapping.

## 2.2 Problem, cont.

### **Residential Single-Family 5 Units Per Acre (RSF 5) Zoning Excerpts**

*Permitted accessory uses and structures:* Uses and structures that are customarily accessory and clearly incidental to permitted uses and structures, including approved conditional or special exception uses, are permitted in this district, including, but not limited to:

Accessory structures, including, but not limited to, garages, carports, and sheds.

1. Detached accessory structures greater than two hundred fifty (250) square feet but no greater than four hundred (400) square feet in area. All roofs must be pitched and include overhangs and eaves which meet current building codes. Rounded corners are prohibited. These structures are allowed with metal siding in the same color as the primary structure. If an exact color match is not possible, a complementary and non-contrasting color may be allowed.
2. Detached accessory structures greater than four hundred (400) square feet but no greater than one thousand five hundred (1,500) square feet in area allowed with wall or leg heights no more than twelve (12) feet tall as measured from the point of installation (grade level). Any increase in wall or leg height greater than twelve (12) feet may be allowed with an increase of required setbacks (all sides) of five (5) feet for every one (1) foot of height increase. All roofs must be pitched and include overhangs and eaves that meet current building codes.
3. Detached accessory structures greater than one thousand five hundred (1,500) square feet must be site built and constructed of the same materials as the primary structure. Any increase in wall or leg height greater than twelve (12) feet may be allowed with an increase of required setbacks (all sides) of five (5) feet for every one (1) foot of height increase. All roofs must be pitched and include overhangs and eaves that meet current building codes. Rounded corners are prohibited. Colors must match those of the primary structure.
4. The total area of all detached accessory structures shall not exceed ten (10) percent of the parcel size or one thousand (1,000) square feet, whichever is greater, for a property less than one-half acre in size. If the property is one-half ( $\frac{1}{2}$ ) acre or more in size, the total area of all detached accessory structures shall not exceed three thousand (3,000) square feet.
5. Detached accessory structures shall be located behind the leading edge of the living area of the residence except garages and carports, which must still maintain required setbacks.

## 2.2 Problem, cont.

6. Conditional uses and structures (C): (For rules and regulations for any use designated as conditional uses and structures.)
7. 1) Bed and breakfast, one (1) or two (2) bedrooms.
8. 2) Guest home.
  - a. Provided the lot area shall not be less than twice the minimum lot area required for a single-family dwelling.
  - b. Must be under one (1) ownership.
  - c. Must comply with all development standards within the appropriate zoning district.
  - d. Must be built of the same materials and in the same color scheme as the principal dwelling.
  - e. Impact fee<sup>24</sup> shall be assessed as a dwelling unit.

*After reviewing the description, aerial view of the property, and zoning excerpts, what questions might you have to determine if the subject property includes an ADU? Using the data presented, answer the following questions.*

1. *Based on this information, are there any issues present that might either positively or negatively influence the market value of the property?*
2. *Is there other information you believe is necessary to identify the 2-bedroom, 1-bath improvement as an ADU?*
3. *Does the subject property meet the zoning ordinance requirements?*
4. *Does the subject property meet secondary mortgage market appraisal guidelines for lending purposes?*

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24. Impact fees. A one-time fee imposed by local governments on the property developer. The fee is to offset the financial impact of new development on public infrastructure, roads, schools, utilities, and other services.

## 2.2 Problem, cont.

5. How would you address these questions in the highest and best use analysis?

*The detached unit may not have a kitchen; therefore, it is not an ADU according to the secondary mortgage market appraisal guidelines, i.e., Fannie Mae or Freddie Mac. According to zoning, this would be a "guesthouse." Assuming the details provided are correct, the additional unit meets zoning requirements. The guesthouse sits on a separate lot; however, the primary structure encroaches on the second lot. If sold off as a separate building site, the encroachment would have to be considered. In that case, the septic system would have to meet rear setback requirements. The guesthouse does not have a separate drive or walkway to the unit. If this were a comparable sale or a subject property with only an exterior inspection or desktop analysis, it would be advisable to contact the parties involved, e.g., owner, buyer, renter, real estate agent and verify the description of the additional unit and confirm if it does or does not have a kitchen. Other sources might also be the MLS photograph gallery for the subject property (or comparable sales), which may show photographs of the separate unit. The highest and best use would summarize the relevant factors in the subject property's zoning that support the conclusion the primary residence is legal conforming, and the guesthouse is legal nonconforming, including an explanation of what factors resulted in that conclusion.*

## 2.2 Problem, cont.

*Therefore, this conclusion meets the physically possible highest and best use test since it does have two lots per zoning. The financially feasible test would be determined after searching the market for sales, listings, pendings, and rentals of properties with guesthouses to identify the market reaction to this secondary improvement. If the market supports a contributory value and demand for properties with guesthouses, it would be a financially feasible property improvement. Recognize, however, that research and analysis of the data collected determines if the subject property's guesthouse contributes positively, neutrally, or negatively to the overall value conclusion, not simply the fact that the guesthouse exists.*

6. In the appraisal of this property, should the impact fees be included? Explain.

*Impact fees apply if the secondary improvement meets the ADU requirements (i.e., includes a kitchen). If it is an ADU, that would increase the cost to build if the improvement did not already exist. However, if applicable, this conclusion would require a summary explanation under the financially feasible test as vacant.*

## 2.3 Problem



Review the 1004 Appraiser Certification and identify the items that require attention in the appraisal.

1. **Certification 4:** 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.

*In markets where ADUs are in the early adoption stage, comparable sales may not be ideal. This requires disclosure, a summary of the data collected and verified, and the analysis performed in the highest and best use and in the sales comparison approach to ensure an intended user can understand how the opinions and conclusions were developed. For example, it is important that a description of the market trends for ADUs in the subject neighborhood/market is provided and supported.*

2. **Certification 7:** I selected and used comparable sales that are locationally, physically, and functionally the most similar to the subject property.

*If the sale data (including pending sales) is not truly comparable but the best available (for example, the best after a search for listings, expired listings, withdrawn listings, and dated sales), a cost approach as secondary support may be a good step if the market is active to provide support for cost, site, value, and depreciation. Ask yourself*

## 2.3 Problem, cont.

*and your peers, "Did you take the steps your peers would have taken in the same or a similar assignment?" If so, you have met USPAP's SCOPE OF WORK RULE requirements.*

3. **Certification 11:** I have knowledge and experience in appraising this type of property in this market area.

*In a market where ADUs are in the early adoption stage, the appraiser may not have experience in appraising this type of property. If you have knowledge and experience in appraising residential properties, but the market has few properties with ADUs that have sold and can be used for analysis, these facts must be disclosed to the client. Any such conversation with the client should be documented in your workfile. "Take all steps necessary or appropriate to complete the assignment competently; and describe, in the report, the lack of knowledge and/or experience and the steps taken to complete the assignment competently." (USPAP, COMPETENCY RULE; see ACQUIRING COMPETENCY.)*

***Warning:** An appraiser must have the competency at the outset of the assignment or work with another appraiser who has competency and is acceptable to the client/lender. Working on the assignment for an agency according to their appraisal guidelines or requirements does not count toward gaining competency for the assignment.*



## 2.3 Problem, cont.

4. Does taking a seminar on ADUs result in an appraiser being competent to complete these types of appraisal assignments? Explain.

*Discuss the circumstances with the client. If the issue is a genuine lack of knowledge and experience appraising residential property, including property with an ADU and/or properties with ADUs in which there is a lack of listings, pendings, sales, rentals, etc., similar to the subject property, the appraiser does not meet the requirement of competency at the outset of the assignment as required by the agencies.*

*The seminar meets the first criteria but not the lack of experience part of the statement. To meet the experience portion, the appraiser may need to partner with another appraiser experienced in valuing properties with ADUs and those properties lacking data to complete appraisals for this property type, or the appraiser may need to decline the assignment.*



### **3.2 Dilemma**



*Can a residential state-licensed appraiser take an assignment that is a one- to four-unit property with an ADU that is now considered a five-unit property?*

*The answer is yes for some states and no for others. An appraiser must be aware of the state's licensing law as it applies to residential licensed or certified credentials. A client also needs to be aware of this dilemma because a client might not be comfortable housing the loan if there is no buyer for it. In addition, the client needs to know if the appraiser is not allowed to appraise the property under the state's licensing law.*

### 3.3 Dilemma



#### **Appraiser Experience with an ADU That Is Not Legal (Steps an Appraiser Could Take)**

The owner of the subject property advises the appraiser that the ADU is not legal; therefore, based on the following discussion, the appraiser decides to value the property in the following manner:

1. The appraiser will contact the client/intended user and advise them of the circumstances. **Note.** It is important that the client agrees with the approach being taken by the appraiser in completing the appraisal assignment.
2. If the intended user(s) is acceptable to moving forward with the appraisal assignment following the appraisal process discussed, the appraiser will check the master plan and current and anticipated zoning for the subject property.
3. Thereafter, the appraiser will speak with the zoning/code enforcement personnel to determine if the ADU could become legal and what that effort would entail. If the conclusion is that the subject property's ADU has a reasonable and plausible course of action to become legal under the current zoning, the appraiser will contact the intended user to discuss these findings.
4. Based on the appraisal assignment conditions and a discussion with the client, the appraiser is asked to value the property subject to a hypothetical condition. The condition will include the subject property being reclassified as a legal one-unit property with an ADU as of the effective date of the appraisal.
5. The appraisal report will summarize the support, including data collected, conversations with the zoning/code enforcement personnel, sources used in the value opinion conclusions, and research completed. To ensure the client can understand the appraisal, the appraiser will provide a summary in the appraisal report of the conversation with code/enforcement personnel regarding the current illegality of the subject property as well as the steps necessary for the subject property and the ADU to become legal. The workfile will contain all other data, information, and documentation collected but not necessary for the client to understand the appraisal report. *Is this the correct approach?*

*Yes. The Fannie Mae and Freddie Mac guidelines do address the ADU that is not legal/or permitted. These are eligible for financing under certain*

### 3.3 Dilemma, cont.



#### Appraiser Experience with an ADU That Is Not Legal, cont.

*circumstances that would be necessary to satisfy in the appraisal process.*

*Also, remember that appraisers are not experts on either code enforcement or underwriting. It is important to contact the client as issues arise with information the client did not know about. The appraiser's job is to solve a client's problem, not create a problem. Reviewing the strategy for completing the assignment with the client is also responsible. It will assist the client in determining its ability to underwrite the loan.*

*Overall, the approach(es) would depend on the intended use, intended user, and highest and best use analysis. Is the current use as an ADU? Is this property typical in the market (i.e., using and disclosing data collected and researched from the market to support that assignment result)? If the appraisal is for nonlending purposes, the intended use, intended user, highest and best use analysis, USPAP and STANDARDS, and state laws that might apply must be considered. Following this process will provide direction on the approach(es) to value for the subject property.*

### 3.3 Dilemma



#### Appraiser Experience with an ADU That is Not Legal, cont.

What if the code enforcement personnel are certain that an ADU is **not** permitted and that there is **no** path for the ADU to become legal? Based on that discussion, the appraiser asks what would need to be done to bring the subject property to a legal conforming status without the qualification of the additional structure as an ADU. Experience in the subject property's market tells the appraiser the most common solution is removal of the stove. Other times, it has been the removal of the entire kitchen.

The conclusions of the discussion with the code enforcement personnel need to be disclosed to the client, along with the approach to the appraisal assignment. No matter what the requirement is to bring the subject property to a legal conforming status, the appraisal report must provide a clear explanation of why the ADU cannot be made legal as well as the requirements that must be met to bring the subject property to a legal status without the additional structure qualifying as an ADU.

Based on the appraisal assignment conditions and a discussion with the client, the appraiser is asked to value the property "subject to" a hypothetical condition. The condition will include the subject property meeting all the code requirements for legal conforming status as of the effective date of the appraisal. In the appraisal report, the following must be disclosed and supported, the data collected, and research completed. Such research must include the conversation with code/enforcement personnel regarding the current status of the subject's ADU and the specific steps necessary to bring the subject property into legal conforming compliance. *Is this the correct approach?*

*Yes. The comment that the code enforcement personnel will require the stove or possibly the kitchen to be removed is concerning. Verify if the enforcement code suggests that a one-unit dwelling cannot have two stoves or kitchens.*

*Disclose the findings in the appraisal report as described above. Again, the intended use, intended user, and the highest and best use analysis should direct the approach taken.*

### 3.4 Dilemma



**First scenario:** Assume an ADU cannot be made legal. The conversion of existing space to living area is located in the basement and includes both access from the exterior and through the primary dwelling (e.g., walkout basement with interior access)? *What are the most appropriate options to value the subject property?*

If the converted space is in the basement, then this area is included in the value only as finished basement space. This is true because an accessory unit is required to be *independent* of the primary unit (i.e., with an expectation of privacy). This means access to the accessory unit must **not** be possible by passing through the primary dwelling unit. With this scenario, the basement is not fully independent since access to the primary unit is not restricted.

**Second scenario:** The ADU cannot be made legal. The converted space or addition in the basement is above grade and again, one of the accesses to the space is through the primary dwelling. With the second scenario, this area *is* included in the GLA (for the same reason as noted in the first scenario).

**Third scenario:** Assume the ADU cannot be made legal. The converted space no longer has access or never had access from the interior of the primary dwelling (e.g., attached garage converted to living space with only an exterior access, detached garage with converted attic space to living area, detached free-standing improvement). For the third scenario, this area is **not** included in the GLA; it is valued as a non-GLA area or an ADU if it meets the ADU requirements of kitchen, bath, living, and sleeping facilities.

**Note.** If the appraiser simply pretends the illegal space does not exist, the appraisal is based on the hypothetical condition that the space does not exist when in fact it does.

### 3.4 Dilemma. cont.



#### Three Scenarios, cont.

*Is this the correct approach?*

*Yes. The intended use, client/intended user, and highest and best use analysis should be the primary factors for the approach to valuing this property. Reviewing the Fannie Mae appraisal guidelines is necessary to ensure the method believed to be accurate for the three scenarios is in compliance. This compliance must be discussed with the client/intended user(s) before completion of the assignment.*



## II. Freddie Mac: Secondary Mortgage Market Appraisal Guidelines and ADUs

B. "A Mortgage may be eligible when the accessory unit is legal, legal non-conforming or illegal based on the unit's compliance with the zoning and land use requirements. The appraiser must identify whether the property is a 1-unit property with an accessory unit or a 2-unit property and report the appraisal on the appropriate report form. The primary factor that differentiates a 2-unit property from a 1-unit property with an accessory unit is the zoning and land use requirements. The appraiser must consider all property characteristics, specifically the unit's utility and the property's highest and best use, when making this determination. The appraisal report must include a description of the accessory unit and reflect any effect the accessory unit has on the market value or marketability of the subject property. A Mortgage secured by a 2- to 4-unit property with one or more accessory units is **NOT** eligible for purchase by Freddie Mac."<sup>30</sup>

1. List the ADU characteristics identified by this guideline.

- *A kitchen* .....
- *A bathroom* .....
- *A separate entrance* .....
- *Is independent of the primary dwelling* .....

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30. Quoted text on this page and the following page came from <https://guide.freddiemac.com/app/guide/section/5601.12>.

### 3.5 Discussion Question.

Why do appraisers have to provide an explanation?



*Because USPAP requires it, even if the requirements/appraisal guidelines do not require it. (USPAP, STANDARD Rule 2-2(a)(x)(1)(3)(5) and (xii))*

### 3.9 Exercise

What are the common differences between zoning requirements and secondary market appraisal requirements (and government agency requirements) for properties with ADUs? Complete the table below by filling in the columns as needed.

<b>Common Differences Between Zoning and Secondary Market Appraisal Requirements (and Government Agency Requirements) for Properties with ADUs</b>		
	<b>Zoning</b>	<b>Secondary Market/Govt. Agencies</b>
<b>ADU square footage</b>		
<b>ADU rooms</b>		<i>All require kitchen, bath, sleeping/living area</i>
<b>Private entrance required</b>		<i>Fannie Mae/Freddie Mac</i>
<b>Site size</b>		
<b>Legally permitted</b>		<i>VA and FHA require legal status</i>
<b>Parking requirements</b>		
<b>ADU can be rented</b>		

### 3.10 Dilemma



#### **Review the 1004 Appraiser Certification and Identify Items That Require Attention in the Appraisal.**

**Certification 3.** I performed this appraisal in accordance with the requirements of the Uniform Standards of Professional Appraisal Practice that were adopted and promulgated by the Appraisal Standards Board of The Appraisal Foundation and that were in place at the time this appraisal report was prepared.

**Question:** How do appraisers certify to this statement when the secondary lending guidelines define an ADU differently than the zoning jurisdiction?

*Zoning may not require a bathroom; therefore, zoning may identify such ADUs with a special term, but it does NOT meet lending guidelines as an ADU. This requires special attention in the highest and best use discussion about the ADU improvement and its similarity to the primary structure versus an independent living area.*

- *How does the market react to this space?*
- *Was the space created to accommodate extended family use or the owner's personal use as an office, for example, rather than use an independent rental?*
- *If the data collected and analyzed supports that the market would recognize such an improvement as part of the primary living space rather than as an independent accessory unit because there is no bathroom for this space, this must be explained in the appraisal*

### 3.10 Dilemma, cont.

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**Review the 1004 Appraiser Certification and Identify Items That Require Attention in the Appraisal.**

*report to avoid being misleading. Explain that the market treated this type of improvement as part of the GLA and not as an ADU. This should be supported by the data used in the approaches to value such as the sales, pendings, listings, rentals, etc..*

**4.1 Dilemma**



**(Property A)**

“This renovated home is 90%+ new, highly energy efficient, in Uptown! Main Home: 1,848 sf (2BR, 2BA + Den); Detached Casita: 613 sf (incl. Kitchenette, BA & closet) + 2 Car Garage! Great floor plan with Living/Dining & separate Family Room. Porcelain tile flooring t/out. Gorgeous Kitchen featuring contrasting Soapstone and Quartz counters. MBR w/well appointed Bathroom. Super spacious casita well-suited for personal use, long term rental or high-end Airbnb-\$\$\$! Enjoy all new sewer, plumbing, electric, roof, HVACs, finishes and more in a charming No. Central ranch home. From insulation to air sealing, dual pane windows, and more, this home earned a 63 HERS score - meaning high energy efficiency and low electric & gas bills. This home also was awarded Gold level Pearl Certification for its energy efficiency characteristics. All work by licensed contractor, fully permitted by City of Phoenix.

Located in a great Uptown location, close to Uptown Plaza, St. Francis, Light Rail, Postino’s, Windsor, Joyride, Federal and on and on.. Charming, friendly street with much pride of ownership.

Refer to Scope of Renovations, Floor Plan, and HERS Test report in Docs tab.”

**(Property B)**

“Main house is energy-efficient, low HERs score/all shopping minutes away/freeway to CBD<1 mi./approved detached in-law unit includes a kitchen, bathroom, bath, & living room/public records 750 SF/huge plus unit can be legally rented with lease or used as Airbnb per owner/Income from unit can be provided upon request.”

*What did you conclude from reading the MLS descriptions?*

**Property A.**

*It is an energy-efficient property.*

*It is located close to services.*

*Main structure and casita square footage are broken down.*

## 4.1 Dilemma, cont.



*Casita is detached and subordinate to the primary structure.*

*Casita has a kitchen and bath, and meets secondary mortgage market ADU requirements.*

*Casita is permitted.*

*Casita can be long-term rental or Airbnb.*

### **Property B.**

*Main dwelling is energy-efficient. (ADU may not be.)*

*It has an energy rating - HERs.*

*It is close to shopping and freeway.*

*ADU is detached and has kitchen, bedroom, bath, and living area, 750 sq. ft..*

*It can be rented or used as an Airbnb.*

*Rental income is available.*



## Digging Deeper

### 4.2 Discussion Question

Does this scope of work discussion accurately describe the steps necessary to develop a credible value opinion for a single-unit house with an ADU? If not, what is missing?



*No, in most cases the single-unit property with an ADU requires more extensive research as follows:*

- *Interview of planning and/or zoning department staff regarding legal status*
- *Appraiser needs to obtain and read the zoning ordinance to determine if the property is legal, legal nonconforming, or an illegal use.*
- *If the ADU is leased, the lease should be analyzed. Data sources should be collected, researched, and analyzed for determining the application of the income capitalization approach or using this approach to support adjustments in the approaches to value.*



## Digging Deeper, cont.

### 4.2 Discussion Question, cont.

- *A more detailed analysis of the four tests of highest and best use is required to identify the appropriate comparable sales that would compete with the property.*
- *A more thorough search of data sources to obtain comparable sales, listings, pending sales to apply to the approaches to value is necessary. Verification of all data may not be possible with a party involved in the transfer; therefore, there is a need to identify such limitations, describe the effort undertaken to try and obtain the data disclosed, and then explain in the appraisal report the effect on the assignment results.*
- *Support for the market's reaction to ADUs may be limited, requiring research in a similar market area or research of current listings as well as expired and withdrawn listings. If so, disclosure of the neighborhood or market characteristics and an explanation why such a market is similar to the subject's market is necessary and will also assist in supporting conclusions regarding the market reaction to the subject's ADU and comparable sale data chosen in the approaches to value for the site, sales, and income, where applicable.*
- *Disclosing what was **NOT** done is as important many times as disclosing what was done. For example, was the appraiser able to fully inspect the ADU? Also, if the appraiser believes his peers might collect, verify, or analyze the data differently, but in this assignment, it does not apply, the appraiser should disclose that fact with an explanation why.*





## Digging Deeper, cont.

### 4.2 Discussion Question, cont.

- *In this complex appraisal assignment, data limitations for the subject property and the data used in the approaches to value (or otherwise) should be clearly presented. For example, the accuracy of a comparable sale's ADU features may not be completely possible, including verifying the existence of a living area, kitchen, bedroom, total room count, quality of construction, condition, and/or obtaining income and expense data for an income-producing ADU.*
  - *Reminder. Neither the GSEs nor government agencies purchasing, insuring, or guaranteeing residential mortgages with ADUs allow any other extraordinary assumptions beyond those preprinted in the report form under Definitions, Limiting Conditions & Assumptions, and Appraiser's Certification (beyond those required under a professional organization's code of ethics/standards). However, a well-written scope of work cannot be rejected, and appraisers are encouraged to include an explanation of their work on the appraisal report form.*
-



### 5.3 Discussion Questions

An appraiser used a paired-data set to establish an ADU value and converted it to a percentage of the sale price. Using the previous paired-data set as an example, ( $\$75,000/\$790,000=9.5\%$ ), this percentage adjustment is used as an ADU adjustment in the sales comparison approach for future appraisal assignments. Is it an acceptable practice to convert the ADU dollar adjustment to a percentage for use in all similar ADU appraisal problems? Why or why not?



*No, it is not an appropriate use of the paired-data results. ADUs vary in size, age, quality, condition, room count, and attached versus detached, not to mention location. The percentage may change as the price of the overall property changes, and variations in location affect the results. An ADU may have more value to a particular price range, neighborhood, and/or buyer type.*

### 5.3 Discussion Questions, cont.

For example, review the use of a percentage adjustment below as applied to a variety of sale prices and see how wide the adjustment becomes. Apply logic and answer the question, “Does it make sense?”

Comparable #	Percentage	Sale Price	ADU Value	ADU Sq. Ft.	ADU \$/Sq. Ft.
1.	9.5%	\$1,675,000	\$159,125	700	\$227.23
2.	9.5%	\$575,000	\$54,625	475	\$115.00
3.	9.5%	\$250,000	\$23,750	400	\$59.38

*9.5% × \$1,675,000 is \$159,125 = ADU is 700 square feet*

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*9.5% × \$575,000 is \$54,625 ADU is 475 square feet*

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*9.5% × \$250,000 is \$23,750 ADU is 425 square feet*

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*Using a percentage adjustment may not reflect a reasonable value indication without further support and understanding regarding the differences in size, quality, condition, amenities, and location that may differ widely in ADU properties.*

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## 5.6 Dilemma



### Limited Parking

The owner of the property applied for a refinance loan with a local lender. The lender hired an appraiser to complete the appraisal report for the loan. The following is a description of what the appraiser identified at the time of inspection as part of the appraisal assignment.

The subject property is a small house with a short, single-car driveway that leads to a detached, two-car garage with an ADU above the garage that is about 10 yards from the small house at the front of the lot. Both housing units are rented to independent third parties. The neighborhood is pricey, and there is demand for housing units. The renters have to interact with each other since the parking arrangements are not adequate. This entails moving cars to allow one of the tenants to exit the property because off-street parking is not allowed. *What are the initial thoughts of the appraiser? What do the lender's appraisal requirements and applicable agency guidelines or requirements state about one-unit properties with an ADU rental? What questions might the owner/borrower expect the appraiser to answer in this dilemma? What additional facts might the appraiser need to determine about the potential ADU tenant?*

- 1) Will the lender or property owner provide a copy of both leases or the agreement for rent in place; the Schedule E of the owner or the operating income data for both units and the property overall; details on capital expenditures like a new roof, windows, or interior updating or remodeling; and details on how payment for expenditures was made? (For an income property: If the appraiser is geographically competent, the appraiser should know if this is an income property neighborhood/market area, or if the subject property is an anomaly.*
- 2) None of the agencies will give any credit for the ADU income when completing the loan analysis. The lender will give credit for the rental*

## 5.6 Dilemma, cont.



### Limited Parking, cont.

*income from the primary property. Recommend: The appraiser can contact the client to understand how the client wants to proceed based on the limitations of the income for the ADU. For example, does the client still want the appraiser to complete a rental survey for the ADU?*

*3) Key issue to tackle: Is the parking arrangement a functional detriment to the subject property? The two important questions to answer are:*

*Does the parking arrangement affect the ability to rent the property, and does it affect the rental rate for the property? Possible questions to ask the owner/borrower are: Has a potential tenant refused to rent because of the lack of an assigned parking space or off-street parking?*

*Have renters vacated sooner than the expiration of the lease term citing the parking issue as the reason? What is your tenant turnover rate, and how long does it commonly take to rent the units? The appraiser should ask for the last three years of rental data?*

*4) Other factors to consider: Is the ability to rent and the rental income less due to the proximity of the units to each other, which results in a lack of privacy?*

## 5.6 Dilemma, cont.



### Limited Parking, cont.

5) Specifically, what is the distance of the following from the subject property?

Public transportation, major employment centers or other driving

factors like schools, universities, technical institutions,

daily shopping and other shopping, entertainment,

transportation routes (i.e., freeways, thoroughfares)

6) What is the occupancy allowed?

## 5.7 Dilemma



### Lenders Advise Value of ADU

This dilemma is based on an interview with an appraiser about ADUs in his market in which the following was reported.

Lenders told the appraiser that ADUs are not appraised as additional square footage. ADUs are appraised as an amenity, like a swimming pool or garage, and placed on one of the open lines in the sales comparison grid. Further, appraisal reports that have been reviewed by these lenders where an ADU is present have been adjusted at \$50,000. However, there is no support provided for this adjustment in the sales comparison approach.

The appraiser gave the lender the following points regarding his view of an ADU's value:

1. My view is from the buyer's perspective.
2. ADUs do NOT carry the same price per square foot as the primary house.
3. Research shows buyers of a two-bedroom, one-bath primary house with an ADU are willing to pay more than for a similar house without an ADU. The ADU has contributory value.
4. However, data shows that a two-bedroom, one-bath primary house with an ADU sells for the same as a three-bedroom, two-bath primary house with no ADU. This suggests the ADU takes the place of the third bedroom and second bathroom.
5. The value of ADUs is limited in the market and the best comparison is the two-bedroom, one-bath primary house with an ADU compared to a three-bedroom, two-bath primary house without an ADU.

The lender asked the appraiser what their conclusion is based on these comments.

The appraiser responded, "The resale value of the ADU is not coming from the sale of the property. If the ADU can be rented legally, then the appraiser must analyze the rental income and expenses to determine if a great return can come from the rental status."

1. *Are the opinions from the lenders appropriate and relevant? Explain.*



## 5.7 Dilemma, cont.



### Lenders Advise Value of ADU, cont.

*The lender can provide an appraiser with information the lender observes in the market or on appraisals, but suggesting a value amount could be considered as putting pressure on the appraiser to assign a similar value. This might be construed as a violation of Appraiser Independence Requirements<sup>59</sup> (AIR).*

***Warning:** If the appraiser takes a future assignment from this lender and the subject property has an ADU, a good solution would be to have in writing (such as an email) that it is clear the lender is not suggesting from these comments that the appraiser will automatically apply a \$50,000 adjustment to any transaction used in the valuation of the subject property that does not have an ADU. This statement and the engagement letter should be in the workfile. The reasoning: Both parties could be accused of collusion in a scenario such as the following: The appraiser is hired by a lender with this belief; and the property being appraised is a one unit with an ADU; and the appraiser applies a \$50,000 adjustment to the comparable sale without an ADU, especially if the analysis with the support for the adjustment is not clear and convincing but instead subjective and vague in nature.*

59. <https://www.law.cornell.edu/uscode/text/15/1639e>

## 5.7 Dilemma, cont.



### Lenders Advise Value of ADU, cont.

*Reminder: Certification Item 9 states, "I have reported adjustments to the comparable sales that reflect the market's reaction to the differences between the subject property and the comparable sales." Certification Item 16 states, "I stated in this appraisal report my own personal, unbiased, and professional analysis, opinions, and conclusions ..." Certification Item 18 states, "My employment and/or compensation for performing this appraisal or any future or anticipated appraisals was not conditioned on any agreement or understanding, written or otherwise, that I would report (or present analysis supporting) a predetermined specific value, a predetermined minimum value, a range or direction in value, a value that favors the cause of any party, or the attainment of a specific result or occurrence of a specific subsequent event (such as approval of a pending mortgage loan application)."*<sup>60</sup>

60. USPAP, STANDARDS RULE 1-4 Intro and 1-4(a): "In developing a real property appraisal, an appraiser must collect, verify, and analyze all information necessary for credible assignment results  
(a) When a sales comparison approach is necessary for credible assignment results, an appraiser must analyze such comparable sales data as are available to indicate a value conclusion." (USPAP, 2020-2021 ed.)

## 5.7 Dilemma, cont.



### Lenders Advise Value of ADU, cont.

2. How does considering an ADU's rental income and not resale value address the financial feasibility?

*If the ADU has rental income, it would suggest it has value and an income approach might be applicable. The analysis of the 2/1 with an ADU against a 3/2 without an ADU tells you the ADU has value - is the value \$50,000 - it is implied. The real issue comes from the return since an appraisal report has a market value definition that requires the assumption of a sale - if the property were sold today - the extra value from the ADU is limited because the market/buyers would buy a 3/2 if available over a 2/1 with an ADU. Therefore, the 2/1 with an ADU does not fully meet the market's needs. However, if the property could be rented, would that "beef up" the return beyond the result of this paired-sales analysis (and lump-sum adjustment)? That is the unknown, but it should be explored. At the time of the interview, the appraiser had not analyzed the rental aspect of the 2/1 with ADUs yet. An adjustment for the ADU can be derived as stated in the question, but the unknown question is whether the rental income can give the property owner an even bigger bang for his buck.*

## 5.8 Dilemma



### Basement Units With a Valid Business License

Paired-data analysis in a metropolitan city of two identical basement apartments in an adjacent row house may be valued differently due to the legal status of the permitted uses.

For example, R-4 zoned basement rental apartments are permitted provided the following:

- Both permitted dwellings are at least 900 square feet. (Anything less than 1,800 square feet total only allows for one unit.)
- A business license and certificate of occupancy can only be obtained if the property has 1,800 square foot minimum lot size. If no license or certificate, no value can be attributed.
- Contributory value for a basement apartment ADU with a valid business license and certificate of occupancy ranges between \$25,000 and \$35,000.

1. *Is the value difference for the ADU, or is it for the legal status (business license and certificate of occupancy)?*

*It is highly unlikely the value conclusion is solely attributed to the valid business license and certificate of occupancy. A business license and certificate of occupancy are not attainable without the ADU or basement apartment. A relevant fact was not disclosed: the cost to obtain the license and certificate of occupancy.*

## 5.8 Dilemma, cont.



### Basement Units With a Valid Business License, cont.

2. List the steps to address value in the row house without a business license or certificate of occupancy.

*This is a highest and best use analysis where the appraiser must answer the question, "How does the market assign value in this type of property?"*

*Is there a market for properties with ADUs that do not have a business license and certificate of occupancy?*

*Survey real estate agents and ask if this is a concern for buyers.*

*A prudent investor/buyer would most likely consider the cost to properly license the unit and obtain a certificate of occupancy. The amount then becomes a cost to cure.*

## 5.9 Dilemma



### Basement Apartment Without a Valid Business License

Properties with finished basement apartments often rent to nonrelated parties whether or not they have a valid business license and certificate of occupancy for independent rental use. In this case, the appraiser does not assign any value to the apartment.

*Should the value be zero if the apartment is not properly licensed and a certificate of occupancy obtained? Explain.*

*This is a highest and best use analysis that should consider the potential ability and cost to acquire the required license and certificate of occupancy.*

*Depending on the answer, a call to the client to inform the client of a nonpermitted use at the subject property is necessary. It is possible that the lender/client may not go further with the assignment. Waiting until you complete the assignment without a discussion and clear direction, involving agreement with the client about how to proceed, is unprofessional. Your job is to solve the client's problem, not create a problem.*

*A study of the market to understand how buyers and sellers would consider this circumstance should be the basis of the appraiser's conclusion. The key questions to resolve are: Does a property's ability to obtain a valid business license and certificate of occupancy affect the ability to rent the basement units and the rental rate for such units? Other considerations might be:*

*Do basement rental units with the necessary site size automatically obtain valid business licenses and certificates of occupancy, or does it depend on the rental rate the unit can achieve due to the cost of obtaining those*

## 5.9 Dilemma, cont.



### Basement Apartment Without a Valid Business License. cont.

*items? Are renters concerned, and do they show resistance to renting a basement unit when the unit does not meet the site requirements and, therefore, cannot obtain a valid business license and certificate of occupancy? Do units with valid business licenses and certificates of occupancy rent for more or rent faster than those without them?*

**Reminder:** *Appraisers are not in charge of code enforcement and must avoid appearing as such (unless the appraiser holds such expertise).*

*Appraisers are real property valuation professionals. A short survey of real estate agents and other appraisers can add credibility to the conclusions. Appraisers cannot just ignore the space without applying a hypothetical condition.*

## 5.10 Dilemma



### A Legally Permissible ADU Requires Registering the Improvement

A residential appraiser provided the following comments about his experience with ADUs.

“The first step is always to analyze the highest and best use. An initial step is to determine if the subject is legally permissible. This requires an understanding of the subject’s community and its master plan along with the subject’s zoning. Is the use a single-unit with an ADU, or is it a multifamily dwelling? In this dilemma, the zoning authority requires registration. There is no zoning classification for an ADU that was illegally constructed. Instead, the key issue comes down to is an improvement like an ADU registered?”

1. *Assuming a property with an ADU is legal but has not been registered, what steps would you follow to provide an as is value?*

*Provide a discussion of the zoning and the process, cost, and timing to register the improvement. Appraise the property using comparable sales with ADUs, and apply a "cost-to-cure" to arrive at an as is value. The other alternative is to find similar legally zoned properties with an ADU that are not registered and were sold as such.*

In this market area, if the ADU is not in compliance with zoning, a survey of the vicinity should be done to identify other properties that are also noncompliant with zoning. This is similar to the agencies’ requirements to show market acceptance. If the survey shows this is accepted in the market area, the zoning department classifies the property as “legal nonconforming,” and the appraiser would then explain and show it as legal with full disclosure of what makes it legal.



## 5.10 Dilemma, cont.



### A Legally Permissible ADU Requires Registering the Improvement, cont.

2. What are the steps the appraiser should take when the property does not conform to zoning regulations?

1. *Notify the lender/client of the findings.*

2. *Answer any questions they may have and possibly do more research.*

3. *Await the lender's decision to take the loan, understanding it may not meet secondary mortgage market guidelines.*

4. *If the lender says to proceed, the appraiser will move forward as long as the assignment conditions do not conflict with USPAP or agency guidelines (if applicable).*

5. *If the lender says they will portfolio the loan and do not need an agency-compliant report, the appraiser will ask for it in writing and keep it in their workfile, noting it in their report.*

## 5.10 Dilemma, cont.



### A Legally Permissible ADU Requires Registering the Improvement, cont.

“I further add a disclosure statement on Page 1 of the appraisal report form and anywhere else in the report where the value opinion is stated. The disclosure statement is: Per the lender, this loan may not qualify to be sold, insured, or guaranteed by private or public entities due to the legal issues associated with the subject property and the assignment condition requested by the lender/client in developing the opinion of value.”

**Reminder.** For lending assignments, **all** agency appraisal guidelines or requirements mandate the appraisal be completed in compliance with USPAP; no such guidelines or requirements are in noncompliance with USPAP because they either meet the standards or surpass the standards.

3. *What kind of assignment conditions might not be in compliance with USPAP or the appraisal guidelines or requirements of agencies like Fannie Mae, Freddie Mac, FHA, and VA?*

*a. Appraiser is directed to avoid stating the facts regarding the complete legal status of the subject property.*

*b. Lender requests that appraiser not mention the ADU and not apply a hypothetical condition.*

*c. Appraiser is requested to give no value to the ADU and to report the value as is in spite of the fact that the appraiser can support a value of the ADU, or the value for the ADU is negative due to the legal status. See USPAP FAQ 30 for a discussion of similar noncompliant assignment conditions.*

## 5.11 Dilemma



### Setbacks: Legal, Illegal, or Legal Nonconforming

- Some lenders require any property that does not comply with setback requirements to be deemed “illegal” in the zoning classification.
- The problem: This is not true of all lenders. Some state it is a matter of lender/risk tolerance or regulatory requirements by their auditors.
- In this market, the correct step would be for the owner to register the construction in addition to the original structure. (It’s not uncommon for structures in this market to be built without permits, due to owners wanting to avoid paying for permitting and insurance.)
- Owners interviewed about constructing an ADU without a permit report the permitting process takes too long because there are not enough agents to verify the construction promptly.
- These unpermitted structures can go unnoticed by code enforcement until a neighbor calls and complains, or it may happen when the property is listed for sale.
- After the appraisal, a lender will often cancel the assignment once the lack of permit is discovered.
- Lenders commonly require one comparable sale with an illegal ADU. If a recent comparable sale with the same nonpermitted use is not available, other evidence may be acceptable. (Dated sales, listings, expired, rented, etc.)
- One sale in the sales comparison approach does not support evidence that illegally zoned properties are common in the market. Appraisers must show enough properties that support the conclusion.

**Reminder.** The appraisal guidelines discussed in Part 3 note that Fannie Mae and Freddie Mac will purchase mortgages with illegal zoning if specific guidelines, including the appraisal requirements, are met. The VA has specific requirements if the subject property does not comply with current zoning for the subject, but the local authority accepts the subject property as is (see the VA requirements on the next page).

## 5.11 Dilemma, cont.



For an Appraisal Report, USPAP requires the support and opinions developed to be summarized in the report. In this dilemma, it is clear the zoning authorities do not accept this illegal use, and this fact should be clear and unambiguous in the reporting of the subject property's zoning status and in the highest and best use analysis to avoid being misleading. The following is an example of VA appraisal requirements and zoning compliance:

**Zoning Compliance:** "The property must comply with all applicable zoning ordinances."

**Legal, Non-Conforming Use:** "If the property does not comply with current zoning ordinances, *but is accepted by the local authority*, the appraiser must describe the property as 'Legal Non-Conforming' and comment on the property's marketability and any adverse effect this classification may have on value. The appraiser must state whether or not the dwelling may be legally rebuilt if destroyed." [Italics added for emphasis.]

**Source:** VA Pamphlet 26-7, Chapter 12, Topic 12b, Dated 3/28/2019, P. 12-17.

What can you draw from this scenario regarding the setbacks and legal status?

*Communication with the lender/client or appraisal management company (AMC) should take place before proceeding since all lenders/clients do not have the same risk appetite, may have greater regulatory flexibility or not, or have a stronger understanding of or relationship concerning the lending regulations, including appraisal guidelines or requirements of the agencies they sell to, insure, or engage with in loan guarantee transactions.*

## 5.12 Dilemma



### A Veterans Administration Case – From a Reviewer’s Perspective

The following reviewer observations were made about the appraisals of properties with ADUs for VA lending.

**Note:** The first observation is the most confusing for appraisers and often leads them to incorrect assumptions or valuation conclusions. *Do not make incorrect assumptions based on confusing statements.* Instead, when confronted with unclear issues in the VA appraisal requirements, contact the lender/client and the VA. Do not continue with the assignment until direction has been given by the lender/client and VA. Once again, be sure any direction or request is in compliance with USPAP, at a minimum. The appraiser is responsible for understanding the VA appraisal requirements to ensure the appraisal and the reporting are in compliance.

**Chapter 6 of the VA Guide Item 6b** states – “As part of the highest and best use analysis, the appraiser must determine if the property is a single-family dwelling with an ADU, or a two-family dwelling. The highest and best use must be a legal use (see Topic 10). A two-family dwelling must be appraised on the Fannie Mae Form 1025, *Small Residential Income Property Appraisal Report*.”

The following are additional observations made by VA reviewers about the appraisal reports they reviewed for VA lending of properties with ADUs.

- a. **Rationalizing without evidence.** Rationalizing that the property is a duplex and then stating the zoning is illegal. The basis for this inaccurate action and conclusion is the identification of how many utility meters the subject improvement has and if the primary dwelling and ADU are rented.
- b. **Misunderstanding.** Not understanding that the appraisal assignment is **not** to answer the following question with a simple Yes or No answer: “If the buyer/borrower/veteran purchased the subject property that has an ADU, does the ADU have market value?” A more lengthy explanation than yes or no is needed.
- c. **Does it have value?** If zoning specifically does not allow for an ADU, and the subject property has an ADU, disclose the findings. However, the question that needs to be answered is, “Does the illegally-zoned ADU have value in the subject property’s defined market area?” The VA does not expect an appraiser to act as the code enforcement police. However, the VA does need factual information and supported opinions and conclusions regarding zoning factors.

## 5.12 Dilemma, cont.



### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

- d. **Unsupported marketing conclusions.** The appraisal report identifies the ADU and states, “The improvement lacks marketability in the subject’s defined neighborhood.” However, no research or analysis is provided in the appraisal report to support this opinion. At the same time, data collected on the marketing of the subject property identifies it was under contract in 10 days (DOM). Further, the comparable sales with ADUs used in the sales comparison grid sold in under 30 days and were under contract within 15 days, similar to the subject property. This gives the appearance of incompetency or lack of due diligence in completing the assignment.
- e. **Unable to bracket.** An appraisal report states, “No sales exist with an ADU, so I was not able to bracket the property features. Therefore, it has no value.” When the appraiser was questioned, he said he limited the search to six months and did not consider competing neighborhoods or markets. Also, the appraiser stated, “Only sales were considered; listings and pending sales were not.” This gives the appearance of incompetency or lack of due diligence in completing the assignment.

1. *Why are the number of meters and rental status not representative of the classification as a duplex?*

*An important step in the highest and best use is to review the zoning designation and what is allowed. Zoning may allow the ADU to be rented and may even require separate meters. However, the number of meters does not represent the property type (e.g., single unit with an ADU, duplex).*

2. *Item d above addresses marketability weaknesses. How might the marketability be supported?*

*Marketability can be supported by collecting, researching, and analyzing how many listings (including expired and withdrawn),*

## 5.12 Dilemma, cont.



### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

*pendings, or sales have occurred over a defined period for properties with ADUs. From this analysis, note how many listings and pendings became closed sales, summarizing statistics of these transactions in the appraisal report, e.g., DOM, list-to-sale price ratios, changes in pricing over time, etc. If insufficient data is collected in the subject property's neighborhood, it is acceptable to expand the search to competing market areas (explain how it was determined such markets are competing with the subject's market) and complete the same analysis. In the appraisal report, summarize the findings and concluded assignment results.*

*Consider completing the following additional research and analysis:*

*Review the days on the market (DOM) for single units with ADUs to single units without ADUs. If the ADU property sold in the same amount of time or less, this may be support that the market values and accepts this improvement feature. If the ADU sales are experiencing extended marketing times, this might suggest this improvement feature is not well accepted in this market currently.*

*A survey of active real estate agents in the subject's defined market or competing market areas can provide further support in developing marketability opinions and conclusions about properties with ADUs.*

## 5.12 Dilemma, cont.



### A Veterans Administration Case – From a Reviewer’s Perspective, cont.

*Interview agents involved about issues - positive, neutral, or negative - that occurred with the dated listings and sales during the marketing of the property and in the negotiation of the final sale price - did the seller have to offer concessions or incentives to entice the sale? These efforts could also provide marketability insight.*



## 5.13 Dilemma



### ADU Without a Bathroom

An appraisal assignment notes the property is a single-unit house with an ADU. Upon inspection of the property, the appraiser finds the property is a single-unit house with an ADU that is an attached garage conversion with a separate entrance. However, the ADU does not have a bathroom.

1. Does the lack of a bathroom affect the ability to appraise the property as a single-unit house with an attached ADU? Explain.

*This question might be answered differently in different locations, depending on the local zoning. For example, an ADU without a bathroom would not meet the Fannie Mae definition of an ADU.*

*To meet the definition of an ADU, many zoning ordinances require bath facilities.*

## 5.13 Dilemma, cont.



### ADU Without a Bathroom, cont.

*As part of the highest and best, the appraiser must determine if the space is legal and analyze how the market would react to an ADU improvement. Would the market see this as extended living area or as an independent living area? In this market, is this space usually used for a related family member, or is it rented to a non-family member? In some markets, an ADU improvement might be considered extended living area and part of the gross living area.*

*Appraisers must be careful not to produce a misleading appraisal report or one in which the intended user(s) cannot understand the appraisal without the workfile. Remember, all standardized appraisal report forms are "Appraisal Reports" per USPAP and require summarizing of opinions and conclusions, not simple statements.*

*Therefore, appraisers must be careful to summarize the factual conclusion of what the subject property's space represents and address all the highest and best use issues factually in the appraisal report.*

## 5.14 Dilemma



### Rural Property With ADU Rental

The MLS listing for the subject property identifies its location as rural and with an ADU that is registered as an Airbnb rental. The MLS listing also states: “This property is occupied, and the sellers have two small children. If possible, notify agent the day before viewing to make arrangements. The breezeway connects two homes. Seller needs to request permission to show the cottage because it is occupied commonly with short-term renters.

There are five-bds total but only a 3-bd septic field. Enjoy privacy and serenity at this 23-acre farmette surrounded by open farmland. Enjoy views of the Blue Ridge Mountains from various areas of the property and the driveway.

The well cared for 3-bd, single-level home & the 2-bd guest cottage with a kitchen and bath are well positioned in the middle of the property. The guest cottage (separated by a breezeway) is currently being used year round as an Airbnb rental. This rental has received ‘Superhost’ status from Airbnb with over 100 five-star reviews. It generates an average of \$20,000 in gross profit annually. Guests enjoy the relaxing farm atmosphere and rolling hills. This cottage could also serve as an in-law suite or additional living space for guests.

A small pole barn with a one-horse stall sits inside a secluded fenced-in paddock and has electric service and a frost-free well spigot. There is a small pond and dock on the property as well.”

1. Does this “guest cottage” meet the ADU criteria?

*Yes, it has a kitchen, bathroom, and separate entrance; therefore, it meets Fannie Mae, Freddie Mac, VA, and FHA definitions in their appraisal guidelines and requirements.*

## 5.14 Dilemma



### Rural Property With ADU Rental, cont.

2. Is this property eligible for a Fannie Mae/Freddie Mac mortgage? Explain.

*Yes, it would be eligible for a GSE loan since it does meet appraisal guidelines as a single-unit dwelling with an ADU. However, the septic system will be an item that will require a cost-to-cure and most likely an appraisal value based on a "subject to repair" of the septic system to accommodate the five bedrooms.*

3. What challenges might you expect in developing an appraisal on this property?

*Comparable sales of rural properties are difficult enough without adding the acreage, accessory dwelling unit, pond/dock, and barn to the mix. Further complicating the assignment is the fact that the ADU rental is an Airbnb versus a standard leased rental property.*

4. Assume the appraisal is **NOT** for mortgage lending purposes. Will the \$20,000 gross rent be useful in developing a value of the "guest suite?"

*It would be useful in discussing the financial feasibility of the property and the ADU. The net rent would be important as well if an income capitalization approach is applicable. If the ADU improvement is being used as an Airbnb, expenses would include cleaning and maintaining the unit as well as management functions like making reservations, collecting rents, advertising, and answering calls, etc.*

## 5.15 Dilemma



### FHA Loan and Appraisal on a Property With an ADU

A lender ordered an FHA appraisal on a property with a second unit identified on the appraisal engagement form as an ADU. The lender concluded it was a single-unit property with an ADU because the MLS listing that the lender obtained marketed it as such.

The appraiser verified the zoning as “RES” or Residential Low-Density District, allowing single-unit only. The appraiser determined this two-unit property does not meet zoning because it is a multifamily (duplex) property that is located in a residential low-density zoning district. In the Appraisal Report, the highest and best use summary identifies the zoning and the rent for the ADU, and it states that these factors further support the subject property is a duplex property. Also, the appraiser noted two electric and two gas meters. At present, the property is a pending sale at full list price with no seller concessions. The property was under contract in 10 days from original list date. However, the appraiser was not able to research and analyze other sales similar to the subject property to bracket the property features. The appraiser believes this means that the ADU rental does not have market appeal; therefore, no ADU value is attributed because it is not legally conforming.

*Do you agree with the appraiser’s conclusion that this is a duplex? Explain.*

- *The conclusions do not have good support for identifying the property as a duplex simply because it is zoned for residential, low-density. Further research of what is allowed in this district should be conducted, and that may involve a call to the zoning jurisdiction to clarify the property’s legal status and special exceptions.*
- *The number of utility meters does not determine the use of the property or legal status.*
- *Highest and best use needs to address how the market views the value component of the second unit (ADU) - positive, neutral, or negative.*

## 5.15 Dilemma, cont,



### FHA Loan and Appraisal on a Property With an ADU, cont.

- *A full price offer and only 10 days on the market points to at least one buyer that found value for this property. Reminder: One sale/one buyer is not evidence or support that ADUs are common and/or saleable in the subject property's defined market area.*
- *The fact that there are limited sales to bracket the ADU does not support the claim that the ADU has no value.*
- *If the zoning does specifically allow for an ADU, and an ADU exists, summarize the facts and findings in the appraisal report. However, the following question needs to be answered: "Does the illegally zoned ADU have value in the subject property's defined market area?" The FHA does not expect appraisers to act as code enforcement police. However, the FHA does need factual information and supported opinions and conclusions regarding zoning factors.*

## 5.16 Dilemma



### Historical District Listing



An MLS listing in the historical district of a small city gives a description of the subject property and includes comments about ADU potential as follows:

“Location, location, location and a 1901 gem! One block from the park and waterfront in this sweet downtown historical district. It is walkable or bikeable wherever you’d like to go to enjoy this tropical paradise. All original plank floors, light and bright. The zoning is neighborhood density of 10 units per acre. Check with local authorities to consider possibilities for the outbuilding – easily converted to a garage, studio/gallery, an apartment – whatever your imagination can conjure up! Outbuilding (480 square feet) is currently being used as storage.”

*What steps would you take to form a highest and best use conclusion as improved if this was your appraisal assignment?*

## 5.16 Dilemma, cont.



### Historical District Listing, cont.

- 1. Check the master plan; review the zoning and historical district current maps to determine potential uses of the outbuilding.*
- 2. Research the market to identify the supply and demand for housing and the target audience for this property with an ADU or other possibilities like a conversion to a garage, commercial use, rental based on allowable uses, continued use as storage, etc.*
- 3. If the outbuilding can be converted to an ADU, survey real estate agents regarding the market's reaction to converting the outbuilding to an ADU in a historical district.*
- 4. If the research suggests the outbuilding would be more desirable as a garage, estimate the cost to convert and compare it to the added contributory value. If the contributory value is greater than the cost to convert, compare this answer to No. 5 (below) to determine the financially feasible and maximally productive use of the ADU.*
- 5. If the research suggests the outbuilding would be more desirable as an ADU, estimate the cost to convert and compare it to the added contributory value. If the contributory value is greater than the cost to convert, compare this answer to No. 4 (above) to determine the financially feasible and maximally productive use of the ADU.*



## 5.17 Dilemma



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan**

The appraiser completed the property inspection and market analysis, which suggests that 40% of the properties are rented in this market area. The subject property ADU is rented with a yearly lease that has 10 months remaining on the lease. The appraiser informs the client that an income capitalization approach is applicable; therefore, he must expand the scope of work and increase the appraisal fee. The client advises the appraiser that the ADU rental income cannot be used in qualifying the borrower for the mortgage loan, and the client does not need an income capitalization approach.

*What should the appraiser do?*

*USPAP states, "An appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal." (USPAP, STANDARDS RULE 1-1(a))*

*An appraiser's decision about which methods and techniques are necessary to solve the appraisal problem is largely shaped by the information gathered in response to USPAP STANDARDS RULE 1-2(e), which requires an appraiser to "identify the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal."*

*If the value opinion to be developed is market value and "when necessary for credible assignment results," USPAP STANDARDS RULE 1-3 requires an appraiser to "(a) identify and analyze the effect on use and value of (i) existing land use regulations; (ii) reasonably probable modifications of*

## 5.17 Dilemma, cont.



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.**

*such land use regulations; (iii) economic supply and demand; (iv) the physical adaptability of the real estate; and (v) market area trends, and ...*

*(b) develop an opinion of the highest and best use of the real estate."*

*This tells an appraiser that it will depend upon if the income capitalization approach needs to be completed (i.e., case by case basis for each assignment—NOT a blanket response). It does not matter if it is relevant in the loan analysis or not. Underwriting the loan is not the concern of the appraiser. Concerns of the appraiser are the credibility of the conclusions and the fact that the certification identifies the report is in compliance with USPAP. The following points suggest an income capitalization approach may be necessary if*

- Subject and ADU would be marketed as an income-generating property*
- The property is generating income*
- Income properties are being sought by purchasers*
- Properties are being bought by investors*
- Properties for rent are common in the neighborhood/market of the subject property*
- Data is available on these properties (meaning due diligence and effort are extended by the appraiser to make this determination)*

## 5.17 Dilemma, cont.



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.**

- *Under USPAP, if any of the bulleted points are applicable, or more than one is applicable, an appraiser cannot ignore completing the income capitalization approach.*

*With that said, even if a property has a rental on it and rentals exist in the subject property's market, it does not automatically mean the income capitalization approach is necessary for credible conclusions. For example, a handful of rentals may not reflect a market in which rental properties are common enough to attract income interested buyers. In other words, buyers are still relying on the sales comparison approach and comparing other like properties that may and may not include properties with rentals.*

*There are rental properties in markets that sell to owner-occupants and are taken out of the rental market. And there might be purchasers who turn a property into a rental property. An appraiser must analyze the market with due diligence and be able to explain why the income capitalization approach does or does not apply, and is or is not necessary for credible results. For example, there are rental properties in a nearby neighborhood - some with ADUs are rented. Should an appraiser in this neighborhood use the income capitalization approach? Not necessarily. Why? Because that is not the prevalent purchaser in the market. Based on a trend analysis of buyers, the prevalent purchaser is an owner-occupant buyer.*

## 5.17 Dilemma, cont.



### **Borrower Cannot Use the ADU Rent to Qualify for the Mortgage Loan, cont.**

*However, in the subject property's neighborhood, 40% of the properties are rentals. About 60% of those (40%) are repurchased repeatedly for their income capacity, and currently, more of the homes in that market over the past two years have been purchased and turned into a rental property.*

*The appraiser would be noncompliant if he did not consider the income capitalization approach when completing an appraisal report in the subject property's market. It was found that 25% of the properties in this market have ADUs. In interviewing those owners, more than 60% are rented to non-family members. The subject property's market, as described, should be investigated by an appraiser to determine if the income capitalization approach will produce a credible conclusion. Beyond interviewing the owners and tenants of rented properties in the subject property's market, it would be wise to interview real estate agents/Realtors that currently form that market. This would help the appraiser to determine how the property would be marketed and confirm what types of buyers are commonly coming into the subject property's market today.*

*In USPAP, STANDARDS RULE 1-6 requires the appraisal report to address the applicability and suitability of the approaches used in the reconciliation.*

## 5.18 Dilemma



### Subject Property Has Illegal – Nonpermitted – ADU

The subject property has an ADU that is not legal according to zoning and is not properly permitted. It is under contract, and the appraisal is for a Fannie Mae backed mortgage. Once the appraiser discovered this issue, she contacted the client/lender and discussed the best method to proceed, but the client's answer seems to be noncompliant to the Fannie Mae appraisal guidelines. The client/lender wants the appraiser to consider the zoning for the subject property and the ADU as though they are legal with no accounting in the sales comparison approach for the fact that they are not legal.

The dilemma is that current sales of similar properties with illegal improvements with ADUs are available. The client/lender says, "If Fannie Mae says illegal improvements are eligible for purchase by the agency, it makes sense to just treat these property issues as though they are legal."

*How should the appraiser proceed with this assignment?*

*The appraiser must apply a hypothetical condition to proceed as instructed by the lender. The appraised value would not be an "as is" value, and the lender may be required to buy back the loan once Fannie Mae discovers the hypothetical condition is not removed.*

*The appropriate way to handle this assignment is to show the client/lender in the Fannie Mae appraisal guidelines how this assignment should be handled. (Fannie Mae Selling Guidelines, B4-1.3-05, dated 09/02/2020)*

## 5.18 Dilemma, cont.



### Subject Property Has Illegal – Nonpermitted – ADU, cont.

*The **LENDER** is responsible for confirming that the existence will not jeopardize any future property insurance claim that might need to be filed for the property. (Fannie Mae Selling Guidelines, B4-1.3-05, dated 09/02/2020)*

*Assuming that the appraiser can collect, research, and analyze current illegally zoned properties with ADUs like the subject property and in the subject property's market, it is acceptable to value the property in as is condition. Even if dated sales vs. current sales are necessary to support this scope of work conclusion, it is acceptable to value the property in as-is condition. The highest and best use analysis **must** present a clear and supported explanation that these illegal properties do exist, and the market does not penalize such properties due to their illegal zoning status. However, in the appraisal report, the **highest and best use** must summarize the support that similar properties with illegal zoning exist and transact in the subject property's market to prove the appraiser's market reaction opinion. This can be done with listings (active, expired, withdrawn), pending sales, and sold properties, and these transactions would **NOT** have to be comparable to the subject property, per Fannie Mae appraisal guidelines.*

## 5.18 Dilemma, cont.



### Subject Property Has Illegal – Nonpermitted – ADU, cont.

*When the property [improvement(s)] is not permitted, the appraiser must comment on the quality and appearance of the work and its impact, if any, on the market value of the subject property. (Fannie Mae Selling Guidelines B4-1.3-05, Improvements Section of the Appraisal Report (09/02/2020))*

*If the appraiser does not have two or more comparable sales with similar illegal status to value the subject property, Fannie Mae suggests contacting the client/lender and discussing how to proceed. The appraisal report will not meet Fannie Mae or Freddie Mac appraisal guidelines without them. As a result, the lender may portfolio the loan or may decide to cancel the appraiser order. Thereafter, the appraiser should bill the lender/client for the time spent in completing the collection, research, and analysis of the data reported and the inspection of the property.*

