

## Appraisals and the Cost Approach



**By Brian Madigan LL.B.**

You might be interested in the components that go into an appraisal of your property, when the appraiser uses the Cost Approach. Sometimes, the result is significantly different than the result obtained using the Direct Comparison Approach. That method, of course, simply compares your property to other properties.

However, the cost approach is relatively straightforward when you are a builder and you have just finished your project. You simply add up all your costs, and you're finished.

But, it's a little more difficult to figure out the costs if you are a homeowner and your house is 15 or 20 years old. In fact, the older it is, the more difficult it is to apply the cost approach in terms of coming up with a sensible value.

So, what you have to do is add up the 3 components of the real estate:

**Formula: Building + Improvements + Land = Total Value**

**Step One: determine the cost of the building**

### **Building**

Get current value of building  
Take away depreciation

This is a little different method. You might think that you would take the old costs and add them up. That could work, but that's not the method that is commonly accepted in the real estate industry. The theory is that current costs are easier to obtain and verify.

And, there are three ways to figure out the current building costs:

### **Building Cost New**

- 1) Cost services method..... use recognized manual
- 2) Building cost abstraction method... take away everything else
- 3) Local contractors... get three estimates

Local building contractors and local real estate boards will both publish manuals with established and recognized costs. That's not a bad method. It's a little casual

at times. Fortunately, it is updated annually. One of the real difficulties is its use and application by non-professionals.

The building abstraction method should rarely be used. This is only available as an approach when all else fails. The methodology is that you arrive at the value of the building by taking away the value of everything else already on site.

I'll simply say one thing, I have never (ever) in 25 years of real estate experience seen this particular method work accurately to the exclusion of the other methods. Somehow, appraisers are always able to get this method to "confirm" their opinion derived from using another method.

The third and by far most accurate method is to have it priced out by a building contractor. But, if you are not having one built, because it's already standing on your site, what builder is going to give you a value? Basically, you'll have to pay for it. Then again, it is by far the most accurate number.

## **Building Depreciation**

Now, you come to the next step in the process. How do you figure out depreciation? Basically, you guess! I'm sorry, that's just what you have to do. You take a wild stab at it. It's a 20 year old building, so there has to be some depreciation. We can all appreciate that. But, there is really no scientific method to figuring this out.

So, the real estate industry has come up with a methodology here. This is a simple way of guessing and having it look a little more accurate and a little more scientific in a report.

You deal with two concepts: the effective age and the economic life. Now, neither of these concepts have anything to do with how old the building really is. For our example, the building is truly 20 years old. It was built with "new" and "up to date" materials, 20 years ago.

Next, you have to figure out how long the building will last. Most appraisers will say 50 to 60 years. That's the total lifespan of this building. But that's just the first step. The second step is to figure out the effective age of the building. No, don't jump to conclusions; it has nothing to do with the real age of the building. That is a fact, and we know that it is 20 years old.

So, here's where it gets interesting! We estimate the effective age of the building at a certain number. We could say it's 10 years old, it's 20 years old or it's 30 years old. Then, we have to take that number and divide it by the economic life.

Our results would be:

$$\frac{10}{60} = 0.1667$$

$$\frac{20}{60} = 0.3333$$

$$\frac{30}{60} = 0.5000$$

Of course, this means that the depreciation is either 16.7%, 33.3%, or 50%.

Now, could we have come up with a rough guess in the same way without all the scientific mathematical theories and calculations?

In fact, as time goes by, let's say 60 years and the building is still there and will last some period of time, appraisers will give it another 60 years or so. So, in effect, it has another (its second) economic life. For all I know, maybe the limit is 9, just like cats.

**Effective age = depreciation  
Economic life**

## **Step Two: determine the cost of the improvements**

### **Improvements**

The improvements include anything added of value to the property that is not the actual main house. This would include the garage, landscaping, swimming pool, gazebo, shed, driveway, and site services (that were not included anywhere else).

Get current value of improvements  
Take away depreciation

Again, you figure out depreciation in much the same way as for the building.

## **Step Three: determine the cost of the land**

Get the land value. There are two ways here. First, comparative sales; that means looking at the sales of other similar lands. The second method is abstraction.

## **Land value**

- 1) Comparative sales method
- 2) Abstraction method

If you need to be accurate, then you will have to use the comparative sales method. This is preferred. The correct methodology is to get three comparables, but you could get more. The theory is to go with your three best.

You choose the comparables based upon: time, location, and physical proximity (the closer the better).

With the abstraction method, you have figure out the value of other items, the building and improvements and you are left with the square foot cost for the land. This isn't the best route, but in difficult circumstances it may be your only choice.

## **Summary**

**Formula: Building (less depreciation) + Improvements (less depreciation) + Land = Total Value**

Then, round to closest 500, and now you have your opinion of value based upon the cost approach.

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