The cost approach challenge

It was once said that the best way to get to Carnegie Hall is to “practice, practice, practice.”

For real estate appraisers, practice and education can help to make them more proficient at one of the most misunderstood appraisal methods — the cost approach.

To navigate the sometimes-turbulent waters of the cost approach method of valuation, the appraiser should know the land value, have a cost manual and know a little bit about depreciation.

Barry Cleverdon, IFA, RAA, CRP, an appraiser from Roseville, Calif., NAIFA instructor and AQB-approved USPAP instructor, discussed cost approach with Valuation Review. He defined it as a set of procedures through which a value is derived for the fee-simple interest in a property by estimating the current cost to construct a reproduction of, or replacement, the existing structure plus any profit or incentive, deducting depreciation from the total cost and adding estimated land value.

“The cost approach is an estimate of the replacement value of a property that’s determined by the cost of its components — land and improvements,” he said.

Market-oriented method

The cost approach, Cleverdon pointed out, is market-oriented and involves market data for cost, site sales and the reaction of the purchaser to differences between properties to provide a basis for depreciation charges.

The valuation professional’s judgment is required in making adjustments for property differences and also in estimating elements of accrued depreciation. Formula approaches are inappropriate and could even be misleading.

Taken literally, the cost approach says that someone shouldn’t pay more for a property than the cost of a comparable site and building.

“In its classic form, the cost approach produces a value of the fee-simple interest in the real estate at stabilized occupancy, so the total cost must include any costs needed to achieve stabilized occupancy,” said George Cox, MAI, SRA, a Kentucky appraiser who has written on the subject.

In the cost approach, value is estimated as the current cost of reproducing or replacing improvements (including appropriate entrepreneurial incentive or profit) minus the loss in value from depreciation plus land or site value.

But the approach can become a hurdle for many residential real estate appraisers. A key issue, according to Steve Coull, IFAS, DAC, CAR, a certified NAIFA instructor from Vancouver, Canada, is that many appraisers haven’t been taught anything about depreciation and how to calculate it.

“They don’t want to do the cost approach because they don’t know how to do it properly,” he said.

Coull and Cleverdon agreed that the best way for appraisers to become more proficient in the cost approach is by taking additional coursework in the method. Both teach courses across the country on the subject.

What appraisers can learn

“They can come away from a course understanding the cost approach better, thus giving it more credibility,” Coull said. “No. 2, they will come away with more knowledge. They will be able to use the cost approach without feeling intimidated by it. No. 3, it is a really good basic instruction on using the manual.”

A lot of appraisers maintain the cost approach is irrelevant and doesn’t provide an accurate market value.
“They will say they can’t use it because the house is too old, which tells me they don’t know how to calculate depreciation,” Coull said, adding his response for appraisers is to take courses that teach depreciation and how to abstract it from comparables and marketplaces. “I do find there is a very big problem with appraisers understanding typical life expectancies, effective ages and remaining economic life.”

While some appraisers reserve the cost approach for new construction, Coull said it should be used on each residential assignment.

“There’s no reason not to use it,” he said. “It can be used everywhere.”

Many contend the cost approach is most applicable in valuing new or proposed construction when the improvements represent the highest and best use of the land.

The easy way
Appraisers, Coull said, may be more willing to use the cost approach method for new construction because there is no depreciation.

While the Fannie Mae appraisal report forms don’t require the cost approach, Coull noted if appraisers don’t do it and it is normally done, they have to discuss why it wasn’t done in the report or they could violate USPAP.

“A lot of appraisers do perform the cost approach anyway,” he said. “It really is so easy to do.”

There are plenty of misconceptions about the cost approach, according to Cox, who noted the suggestion that the cost approach sets the upper limit of value is simply not true.

“This implies that the cost new estimate is never understated. More importantly, this procedure implies a preciseness that is not achievable in the art of real property appraisal. In order for this statement to be true, the appraiser would have to develop a perfect land value opinion, a perfect estimate of highest and best use of the vacant site, as well as improved, a perfect cost new estimate, and all four agents of production must be perfectly balanced,” he said.

“Common sense tells us that if two or more contractors were given identical specifications, even for the purpose of constructing a simple single-family dwelling, the results of the individual estimates would differ by varying amounts.”

Out of style?
Nonetheless, the cost approach isn’t necessarily in vogue today.

After Fannie Mae introduced new appraisal forms in November 2005, appraisers were no longer required to supply the cost approach to value.

“If the appraiser deems it applicable and necessary to include the cost approach for a value conclusion, the cost approach should be included,” Cleverdon said. “Otherwise, it is not considered necessary.”

The cost approach, according to Cleverdon, can still prove to be useful when doing assignments for new or pre-construction properties.

“The biggest challenge for appraisers in performing the cost approach is a general lack of knowledge about this method,” Cleverdon said.

Appraisers can find the cost approach useful in situations where market data is scarce and property values far exceed replacement costs.

The cost approach method also offers appraisers an effective way to verify income-based and market valuations and project construction costs. It also adjusts to account for unique physical property features.

Cleverdon noted the cost approach can give appraisers a pure cost-based perspective on the market and their clients a more complete picture of the property valuation.

“The cost approach enables the appraiser to develop an opinion of market value based on the current costs of labor, materials, related fees and any entrepreneurial profit or incentive,” he added.
The mistakes we make

Appraisers who are not well-versed in the cost approach can end up making mistakes that reviewers can’t figure out.

“The review appraiser needs to be able to follow your logic throughout the report,” he said. “When the appraiser doesn’t have a firm grasp on the cost approach, it will show on the report.”

Cleverdon noted the older the structure, the less relevant the cost approach becomes because of the greater subjectivity involved in estimating accrued depreciation. Amenities are usually not reflected in the cost approach.

According to Cox, analytical comparisons, not mathematical formulas or manuals, are necessary to apply the cost approach properly. The appraiser must constantly turn to the market for justification for adjustments and charges.

Cleverdon noted that too often, appraisers rely on crutches and don’t develop adequate analysis to support the opinion of value they arrive at using the cost approach.

“Again, that comes down to simply being poorly trained or lacking experience,” he said. “Today’s appraisers are being trained by appraisers who themselves may not be experienced in the cost approach.”

A major challenge appraisers face, according to Cleverdon, is arriving at a realistic cost to replace new and depreciated calculations available to them, especially in hot markets.

By the book

Appraisers can rely on a number of guides available to help them in developing the cost approach. For example, Marshall & Swift produces its Residential Cost Handbook. Bluebook International produces a similar product, called AppraiserBASE.

Coull told Valuation Review the manuals are a valuable tool appraisers can turn to when completing the cost approach for an appraisal report.

“A lot of times the appraiser simply doesn’t have a cost manual and doesn’t know how to use it,’ he said. “They are intimidated by using it when they do get it or they see other appraisers using it or talking about it.”

Coull added that, many times, when appraisers say the manuals don’t work in their area, the problem is that they don’t know how to use the local multipliers properly.

When it comes to fees, appraisers can sometimes expect to charge a higher fee for work that includes the cost approach analysis.

As a result of the additional analysis, statistical development and reporting required for the cost approach, Cleverdon said he charges about $100 more than a traditional report.

“That is the difference between doing a proper cost approach analysis or simply backing into the analysis,” he said. “I know it is going to take more time and I have to account for it. I know plenty of appraisers out there aren’t doing it right.”

Michael A. Pace, SRA, an appraiser from Cape Coral, Fla., told Valuation Review that because his company is in an area of growth in the Sunshine State, appraisers there supply the cost approach on every report.

“We consider it relevant on almost every appraisal, so we have not eliminated it,” he said. “Several of our lenders also indicated they wanted the cost approach on our reports.”

Pace said Fannie Mae’s guidelines haven’t affected his company at all.

“Personally, I could care less what Fannie Mae requires, as it is my appraisal based on what is necessary for a credible appraisal according to USPAP,” he said.

Bluebook International’s Sylvia San Nicolas said the company relies on feedback from appraisers who use the company’s product to develop and refine the offering.
“At the end of the day, it still comes down to the fact that the majority of the fee appraisers that have not had a
tremendous amount of experience in costing a house out for cost approach purposes are still basically winging it,” she
said. “It is difficult because they don’t have the skills to really understand what it takes to reconstruct or replace a home
for the purposes of the URAR.”

According to San Nicolas, USPAP instructors are telling Bluebook many lenders don’t take it seriously enough or put
enough emphasis on it beyond a validation tool for hazard insurance.

“There isn’t a drive for appraisers to do this,” she said.

There are veteran appraisers who know how to do the cost approach correctly and care about it. On the flip side, there
are appraisers who, for whatever reason, lack the skills necessary to adequately perform the valuation method.

“What we have learned from all walks of appraisers, from your chief appraisers to your new trainees, is that it is really
difficult to figure out,” San Nicolas added. “They don’t have the time, the patience or the drive to truly figure it out and get
it correctly because there isn’t enough attention being paid to it by the lending side.”

One reason for that, Coull said, is the volatility of markets across the country.
In a high-velocity market, the manuals may be tough to use. Coull said appraisers can create their own multipliers to
adjust for market volatility. He said Marshall & Swift and other manual cproduction firms will help appraisers create
multipliers to make the adjustments. Another challenge is understanding the difference between an insurable cost to
replace new for insurance purposes and the cost to replace new for the purpose of the cost approach.

“They are different numbers,” Cleverdon said. “A lot of folks haven’t gotten that an insurable cost includes things like
debris removal, code upgrades and other costs.”

An appraiser performing an insurable cost report outside of the 1004 for a lender client must also look at the individual
property as if it is a total loss. The appraiser has to consider what kind of code upgrades might be required with the new
construction.

“If you’re doing the cost approach to value, as an appraiser you need to know or have reason to know that the lender is
going to rely on it for hazard insurance purposes and you are not disclaiming it, you may not be being true to USPAP,”
San Nicolas said. “It is a material misrepresentation.”

Feedback? We’d love to hear from you on this and other stories. Send your comments to David Hutton at
editor@valuationreview.com.