Professional Excellence Bulletin

Valuation Methodologies

It should be noted that “all three methods” are not equally applicable to every assignment. While, there are more than three methods of appraisal. In historical terms, the, appraisal practice has recognized that there are three main valuation methodologies, namely the Direct Comparison Approach, the Income Approach, and the Cost Approach

Under *The Canadian Uniform Standards of Professional Appraisal Practice* (CUSPAP) the requirement is to “describe and apply the appraisal procedures relevant to the assignment and to support the reasons for the exclusion of any usual valuation procedures. There is no mention within CUSPAP, that all recognized methods be used.

The Appraisal Standards Comments clearly states that exclusion of a valuation method constitutes an EXTRAORDINARY LIMITING CONDITION that requires disclosure with reasoning. The exclusion of a relevant approach must not result in a report that is misleading.

For example excluding the Income Approach from a single family home assignment or the Cost Approach for an older dwelling would not be a departure from CUSPAP, whereas eliminating the Direct Comparison Approach in either case most likely would be. Similarly omitting the Cost Approach for any new single family dwelling would constitute an EXTRAORDINARY LIMITING CONDITION that requires disclosure with reasoning for its omission.

There are, of course, other valuation methodologies that are commonly used, notably the Development or Residual Approach and the Discounted Cash Flow Approach, although the latter can also be included as a derivative of the Income Approach.

The selection of appraisal methods in any assignment is not intrinsically a difficult one. A problem results, however, in the adoption of methods that are not justified. An appraisal report is only as strong as its weakest part, and all methods of appraisal used must be appropriate, accurate and correctly applied. Unfortunately, this is not often the case and the method most likely to be used inappropriately is the Cost Approach.

Most appraisers understand that cost does not always equal value and for that reason care must be exercised when considering use of the Cost Approach to value in an appraisal report. Clearly it is most applicable to new construction, special use properties or where there is an absence of market data or activity to support the more traditional approaches to value. The application of the Cost Approach must be in balance with market conditions and can be developed in appraisals where costs are accepted by the consumers and generally indicative of market value. On the other hand this value test may be excluded from the appraisal in markets where cost is significantly out of balance with overall market conditions and its exclusion is not misleading.

While the Cost Approach is often wrongly included in many appraisal reports, there are other errors that occur in the selection of appraisal methods. The Comparison Approach is perhaps the only method in which the application is fairly consistent. However, its use is not always to be considered mandatory.

Again, where the property exhibits unique characteristics that make the application of the method difficult, the method should not be included. Too many times the approach is used without good evidence, reducing the whole credibility of the report.

In other instances, however, and often outside the major urban areas, the method is excluded on the grounds that there are no suitable comparisons in the area in which the subject is located. This is generally an occasion when the Cost Approach is substituted, despite the age of the building. In reality, in the absence of any local sales, it is often possible to use sales from other areas that have some element of similarity to the subject's location, even if somewhat distant geographically. Adjustments can then be made for any difference in market conditions.

The Income Approach can also cause problems, but there should be one simple principle. If it can produce rental income, then an Income Approach must be considered in the appraisal report. There have been a number of cases, both through the Professional Practice Process and the courts, where the appraiser has omitted the Income Approach, even though the property is, or has the potential to be, revenue-producing. Omitting such an approach hardly adds credibility to either the report or the appraiser, especially if the other side in the dispute includes the approach.

The use of Discounted Cash Flow (DCF) techniques is subject to a number of criticisms, and books have been written on the subject. However, a simple philosophy can eliminate its use in inappropriate circumstances. If the DCF is to be used to obtain an estimate of market value, then the technique must only be used when it is commonly used in the marketplace for that type of property. For this reason, a case can be made for DCF techniques in valuing major shopping centres, office towers, hotels, etc., but not necessarily for other types of income producing properties.

For potential development site valuation, the use of the Residual Approach is also one that has come in for some criticism. It is suggested that, to avoid errors, the Residual Approach should only be used when development of the site is not too distant, there is obvious demand for the resultant product, and there is at least some documentary evidence that such a development will be approved. Ideally, the development or subdivision plans should be available, all municipal consents obtained, and all necessary services available. It is certainly not desirable to take a piece of raw land, assume a potential development, and proceed to the Residual Approach. In addition, the Residual Approach should never be used without using the Direct Comparison Approach in at least a "back-up" role. However, it is equally important, if the Residual Approach is not being used in the appraisal but there is a scheme in place, for the appraiser to reconcile the Direct Comparison Approach with a "back-of-the-envelope" attempt at a residual to test the validity of the Direct Comparison Approach and retain this documentation in the workfile.

The client does not dictate to the appraiser the content of ANY appraisal report. If this causes a problem with the client, then the appraiser is duty bound to either decline the assignment or to provide adequate disclosure within the appraisal as to the limitations of the approach.

CUSPAP References

Appraisal Methods: 8.2.10

Appraisal Procedures 6.2.16, 7.17

Exclusion: 6.2.16, 7.18