

Figure 14.1 Cost Approach Procedure

The procedure for estimating market value using the cost approach is

Estimate the hard and soft costs of the improvements

If reproduction cost is estimated, then losses due to changing building standards and efficiencies will need to be reflected in the depreciation estimate. If replacement cost is used, some losses from changing building techniques will not be addressed in the depreciation estimate.

\$250,000

Estimate and add entrepreneurial incentive

Entrepreneurial incentive is a market-derived figure representing the amount an entrepreneur expects to receive for his or her contribution to a project and risk.* In the case of a shopping center, the costs of construction (hard and soft) do not include any profit for the developer who takes the risk of buying the land, building the building, and renting up the property. Compensation for this risk must be added here. In most residential cost-estimating services, this is already included in the cost manual's cost per square foot amount.

\$25,000

Reproduction or replacement cost of construction

\$275,000

Subtract depreciation

After the cost new with entrepreneurial incentive is estimated, deductions are made to compensate for physical wear and tear, functional losses for superadequacies and inadequacies, and external losses due to economic conditions or locational problems.

– \$50,000

Depreciated reproduction or replacement cost

\$225,000

Estimate and add the net value of the site improvements

Typical items include driveways, trees, shrubs, sidewalks, and landscaping.

\$10,000

Add site value

The site value must always be estimated at the highest and best use of the land as though vacant (ignoring any improvements).

\$45,000

Adjust the indicated value for the rights in realty included with the subject

Again, the cost approach has no inherent way to recognize this adjustment.

\$0

Indicated value via the cost approach

\$280,000

* *The Dictionary of Real Estate Appraisal*, 4th ed. (Chicago: Appraisal Institute, 2002).