Value vs. Cost vs. Price

It is important to understand the differences between the terms **value**, **cost** and **price** as they are associated with the appraisal process. Given the various ways the terms are used outside the field of appraising, often the distinction between them is lost, but the conceptual differences are profound and must be clearly understood by the appraiser.

In brief, **value** is a measure of worth based on the future benefits anticipated to accrue because of ownership of a property. **Price** is the amount of money a seller is asking for a property. **Cost** is the amount of money that the buyer actually paid or will have to pay for a property.

Value

Value is a difficult term to define. It, like time and distance, is a general concept that is best understood if we consider ways in which it can be measured such as by relating value to the current asking prices for comparable properties, or to amounts that were actually paid for comparable properties which were sold in the past. As noted in the below USPAP definition of the term, “value” is expressed as an opinion and not as fact.

Objective vs. Subjective Interpretation

There are two schools of thought regarding value—objective and subjective. Historically, the objective school of thought measured value only by the cost to produce or otherwise acquire the property. Thus, value was based on the item itself without regard to external factors such as need or desirability to own. But the more modern, subjective interpretation of value recognizes the role that external factors have on value—such as future benefits anticipated to accrue as a result of ownership.

As an example, throughout the country a typical household portable generator cost $995 which is the manufacturer’s suggested retail price. In the objective school of thought, $995, then, would represent the value of the property. But what if a hurricane passed through an area causing area-wide power outages? Additional generators that are subsequently shipped to the affected area now sell for considerably more. Why?—because of the extreme need of residents to keep their homes powered up and their refrigerators running. The generator is the same whether or not there was a hurricane. But the subjective point of view of value (which, by the way, we will be use throughout this book when referring to “value”) recognizes that personal property does not have value simply because it exists. It might also have worth because it has value that resides only in the eye of the beholder and, perhaps, to no one else—value that results from benefits that particular individual anticipates will accrue due to his or her owning the property.

For our purposes, we will discuss value in terms of it being a monetary measure of its purchasing power—especially as it relates to the amount of money agreed upon by market participants as being equivalent to the usefulness of a property to fulfill a given need. In other words, the value of property reflects its level of desirability (expressed in dollars) to the owner or to a would-be owner. Value is a measure of future anticipated benefits associated with ownership rights such as the right to make use of, consume, modify, display, donate, etc. (We will discuss this “bundle of rights” later in Chapter 3. See also the Chapter 6 section entitled *“Principle of Anticipation.”*)

Practically speaking, though, value is the amount one (depending on his or her needs and wants) should feel justified in paying if buying (or the amount accepted if selling) and is based on what most other prudent and knowledgeable purchasers have or are paying for comparable properties.

Unlike cost and price which are facts, **value is an opinion**, albeit an opinion with a basis in fact, i.e., value **is always justified** since it is determined by reference to factual market data such as past consummated sales or bona fide asking prices for comparable properties.

USPAP defines Value as:

> *VALUE: the monetary relationship between properties and those who buy, sell, or use those properties.*
>
> Comment*: Value expresses an economic concept. As such, it is never a fact but always an opinion of the worth of a property at a given time in accordance with a specific definition of value. In appraisal practice, value must always be qualified - for example, market value, liquidation value, or investment value.* (USPAP)

All appraisal values are based either from the **perspective of the market** (i.e., a type of "market value") or from the perspective of the appraisal user (buyer, seller, underwriter, adjuster, etc.) In addition, if applicable, mandated value definitions can originate from different sources such as the courts or a regulatory body including the IRS. These two perspectives (along with mandated value definitions) direct the appraiser and impact the appraiser's scope of work decision by defining conditions which will apply to the appraisal. For instance, the following example considers both market as well as user perspectives:

- An appraisal for the purpose of the client acquiring insurance for high value property within certain jurisdictions that define an "agreed value" settlement amount (in the event of a loss) as "market value" would require a definition of market value from a **market perspective**. Developing an opinion of market value from such a perspective would necessitate the use of comparable market data for sales which had occurred under such conditions as:

  - Both buyer and seller are considered well informed, typically motivated, and acting in their own interests.

  - A reasonable amount of time is allowed for exposure on the open market.

  - Payment is made in terms of cash or in financial arrangements comparable thereto, and there is no creative financing or sales concessions.

  - Title will change hands by a specified date.

- The same appraisal assignment has conditions mandated from the **perspective of the user** as well. When acquiring insurance to cover the market value of an insured's high value property, it is understood that the insured would be entitled to replacing the lost property:

- o By purchase from his or her most relevant market, i.e., the market in which the insured most customarily and conveniently shops, and

- o By purchase within a reasonable amount of time

The above example serves to demonstrate the importance of defining the type of value used and the relevant conditions that apply to the assignment. Doing so will help ensure meaningful appraisal reports. This issue will be addressed in greater detail later in this book, but for now remember the importance of identifying the **type** of value as well as its **definition** for all appraisal assignments.

In Chapter 2 we discuss **value** in greater detail. Also, see Chapter 5 for a discussion of "value creators" as well as "value detractors," i.e., "depreciation."

Cost and Price

Cost and price refer to what a **buyer paid** for an item or what a **seller is asking** for an item, respectively. "What is the price of that item?" "Your price is too high." "What did that cost you?" "I thought it would have cost you more." These common usages of the terms cost and price indicate a **relationship** with value but not necessarily an **equivalency** to value. Be aware, too, that it is not uncommon for the terms cost and price to be considered synonymous and to mean the actual amount of money an item brings when sold. We, however, will, as does USPAP, differentiate between the two and use the following meanings for **cost** and **price**:

- **Cost** is the amount of money required to obtain a replacement property by purchase or by construction (known as **buyer's cost**). Cost may be equal to value from time to time, but cost is not synonymous with value. Unlike value which is an opinion, **cost is a fact**.

  USPAP defines Cost as:

  > *COST: the amount required to create, produce, or obtain a property.*
  >
  > <u>*Comment*</u>*: Cost is either a fact or an estimate of fact.* (USPAP)

  Cost is a type of monetary relationship that represents the amount of money that would be required to acquire an identical property or to acquire a comparable or otherwise suitable replacement for a subject property. Cost **is not always justified**, i.e., it may be higher than the item's value on one occasion or lower on another. A buyer may pay too much for a property because of a lack of knowledge or because of an urgency to buy. On the other hand, because of a lack of knowledge or urgency to sell on the part of a seller, the buyer's cost may be much less than the property's value.

  In other words, buyer's cost does not necessarily reflect the value of a property. The buyer might have paid too much, or perhaps the buyer got a bargain and paid less that the item was actually worth.

- **Price** is another type of monetary relationship—one that represents **the amount that is being asked** by the seller for a good or service. (For appreciable property such as antiques and collectibles, price is often set artificially high by the seller in anticipation of having to negotiate downward to induce a sale.) Unlike value which is an opinion, **price**

is a fact. If the asking price is paid, then **price** paid for a property becomes its **cost** to the buyer.

Because of the various motivations of a given seller, the price may or may not have any relationship at all to the **value** which might be ascribed to that property by most prudent and knowledgeable market participants. If one is under pressure to sell, the asking price may be reduced well below the property's actual value. On the other hand, given plenty of time and with the hopes of achieving a windfall profit, a seller may ask an artificially high price that, in fact, far exceeds the property's value.

Like cost, price **is not always justified**, i.e., it may be too high relative to value on one occasion or too low on another.

Assignment Conditions

Assignment conditions are those aspects of the assignment which, if varied, might alter the appraisal results. Included are:

- **Limiting conditions** under which the appraiser must work
- **Extraordinary assumptions** and other assumptions made by the appraiser
- **Hypothetical conditions** which would lead to hypothetical appraisals
- **Jurisdictional exceptions** which might countermand portions of USPAP. (Rarely does this impact on the personal property appraiser.)
- **Other assignment conditions**

An example of an unacceptable assignment condition might be in regards to the nondisclosure of facts. For instance, assume an assignment in which the client is claiming moving damage to an antique table which, while clearly having transit-related damage caused by the carrier, also had preexisting damage which would have a depressing effect on the table's pre-move value (and on the client's hoped-for compensation!) In order to achieve the highest value possible, the client requests that the appraiser value the table without mentioning the preexisting damage at all. Of course, for the appraiser to do so would result in a **misleading** report. To comply with this assignment condition would be unethical. The Conduct section of the ETHICS RULE states:

> *An appraiser must not use or communicate a report that is known by the appraiser to be misleading or fraudulent.*

Limiting Conditions

A limiting condition is a type of assignment condition. Limiting conditions are adverse conditions associated with a particular appraisal assignment that could materially affect the appraisal process and, as a consequence, possibly the value conclusion. For example:

- While on site there may be no electrical power for the appraiser to test the working condition of household appliances. The appraiser may, therefore, choose to assume all are working properly because the client told him so.

- There may be no fuel in the gas tank, making it impossible to start a car's engine to see if it works, and, of course, the appraiser is unable to tear down the engine to examine it for wear. As a result, the appraiser must assume that the engine works and that it has incurred only normal wear and tear.

- The client refuses to allow the appraiser to remove a print from its frame for fear of damage being caused to the print, frame or both. As a consequence, the appraiser must make certain assumptions regarding the print since he or she is unable to inspect it as closely as the appraiser had wished.

Limiting conditions must be disclosed in the appraisal report. Limiting conditions often cause the appraiser to make what are known as **extraordinary assumptions** as was done in the above examples.

Extraordinary Assumptions

An extraordinary assumption is a type of assignment condition. They are assumptions an appraiser is forced to make during the course of an appraisal in order to complete the appraisal process. If made in error, extraordinary assumptions could cause the appraiser's opinions or conclusions to be affected.

Extraordinary assumptions may apply to the property proper or to marketplace issues relating to the property. Extraordinary assumptions are statements assumed to be true so that a conclusion can be drawn. Without making these assumptions, the appraiser would be unable to complete the assignment.

The appraiser's value conclusion is based on information regarding the subject property. Complete knowledge of the property is typically gained by the appraiser through personal inspection of the property. Even so, extraordinary assumptions may need to be made, such as the assumption that the household appliances are in working order despite the inability to test them because of the lack of electrical power. Or that the automobile engine performs to expected standards despite the appraiser being unable to start the car because the keys are missing. If the appraiser is using a sample of the whole on which to base the appraisal, making use of this sampling technique should be noted as it makes necessary the extraordinary assumption that the balance of the whole is similar in condition and quality to the sample that was examined.

Oftentimes property is no longer available for inspection such as property that was stolen or perhaps lost in a fire, hurricane or other natural disaster. In such cases, the appraiser must make extraordinary assumptions regarding the property's value characteristics based on client-provided information such as photographs, descriptions, sketches, etc.

USPAP defines an Extraordinary Assumption as:

> *EXTRAORDINARY ASSUMPTION: an assumption, directly related to a specific assignment, as of the effective date of the assignment results, which, if found to be false, could alter the appraiser's opinions or conclusions.*
>
> *Comment: Extraordinary assumptions presume as fact otherwise uncertain information about physical, legal, or economic characteristics of the subject property; or about conditions external to the property, such as market conditions or trends; or about the integrity of data used in an analysis.*

Extraordinary assumptions must be clearly disclosed in the appraisal report, and the report must notify intended users that the extraordinary assumptions might have affected the assignment results. (The appraiser need not report on the impact of this assignment condition—only that it might have affected the assignment results. (2014-2015 USPAP FAQ #214))

No Label Required

Though an extraordinary assumption might be employed in an assignment, there is no USPAP requirement that it be labeled as such. USPAP requires that the extraordinary assumption be "clearly and conspicuously" disclosed, and that it be disclosed that the extraordinary assumption "might have affected the assignment results," but there is no requirement that it be labeled "extraordinary assumption" although many appraisers choose to do so. (2014-2015 USPAP FAQ #215)

Non-Extraordinary Assumptions

Not all assumptions are extraordinary. Non-extraordinary assumptions are based on information provided by the client and might include such assumptions as the date of death in cases of estate appraisals, the date of donation for a noncash charitable contribution appraisal, that the client owns 100% interest in the appraised property, or that the property has clear title. Disclosing "assumptions" or stating that they might have affected assignment results is not required by USPAP as it is required for extraordinary assumptions.

Hypothetical Condition

A hypothetical condition is another type of assignment condition. Hypothetical conditions are conditions that are contrary to what actually exists as of the effective date of the appraisal, but that are **supposed** to exist for the purpose of the appraisal assignment. Hypothetical conditions give rise to what are referred to as hypothetical appraisals.

As an example, to assist in the determination of an equitable settlement in a damage claims appraisal, you may be asked to determine replacement cost for damaged property assuming it was in good condition and not damaged at all. In such a scenario, you assume a hypothetical condition, i.e., that the property is in undamaged condition when, in fact, it is not.

For another common example consider a client who owns a rare and potentially valuable clock that is in poor condition and that the owner is considering having restored. Clock restoration is often expensive, particularly if the mechanism is complex or if restoration of the case is also