

# factsheet



*Real Estate Appraisal and Property Assessment*

*BCAssessment*

British Columbia's *Assessment Act* requires that every property owner receive a property assessment notice reflecting market values effective July 1 of the preceding year. Market value is the price an unencumbered property would sell for if a reasonable amount of time is allowed to find a purchaser.

Private and public appraisers use a number of generally accepted valuation approaches to develop market value estimates – direct comparison, cost and income. Each approach analyzes highest and best use of the property, most probable use of the property and which use would return the highest value, considering legal, economic and social factors.

## **Direct Comparison Approach**

The Direct Comparison Approach is based on the premise that the value of a specific property is set by the price an informed purchaser would pay for a comparable property, offering similar desirability and usefulness. This requires an understanding of all market variables, including location, property size, physical features and economic factors. Assessors may make adjustments, if required. For example, if an analysis of a property sold in May indicated that the overall market price for similar properties has moved as of July 1 the previous year, an adjustment would reflect the sale price as of last July 1. Since the real estate market changes, the adjustment process is an important part of developing market-value indicators. The process of identifying and analyzing comparable property sales is repeated until a satisfactory range of value indicators for the subject property is established and a final estimate of value is possible.

## **Cost Approach**

The Cost Approach to property assessment is based on the premise that an informed purchaser will judge the value of a property by market price and rents of similar properties, and will also consider the cost of buying land with similar characteristics and constructing a new building. This assumes the cost of replacing the existing building plus the value of the land equals market value.

The steps in applying the Cost Approach include:

- estimating the site value (land and site improvements) through review of comparable sales;
- estimating the cost of replacing the existing building with one of similar usefulness (reflecting current building design and materials); and
- deducting all sources of depreciation, including physical deterioration ('wear and tear' on a building) and functional and economic obsolescence. Functional obsolescence is the reduced ability of the building to perform the function it was originally designed and built for. Economic obsolescence refers to external forces that affect the ability of the buildings to continue to perform, including changes in transportation corridors, new types of building design demanded by the market, etc.

The Cost Approach is most often used when the property being appraised is new or nearly new, where there are no comparable sales, or where the improvements are relatively unique or specialized.

## Income Approach

The Income Approach to value is based on the premise that the value of a property is directly related to the income it will generate. The appraiser analyzes both the property's ability to produce future income and its expenses, and then estimates the property's value. The appraiser also develops a capitalization rate by analyzing the sales of similar income properties and determining the relationship between the sale price and net income.

The steps in applying the Income Approach are to determine the stabilized, net-operating income by:

- estimating potential gross income from all sources;
- deducting an allowance for vacancy and bad debts; and
- deducting all direct and indirect operating expenses.

The resulting net-operating income is capitalized by a market rate, which reflects the property type and effective date of valuation, to produce an estimate of overall property value.

To determine the potential gross income, the appraiser determines market rents by analyzing rents in both the property being assessed and in comparable properties in the neighbourhood. The appraiser makes allowance for vacancy and collection loss.

To determine the effective gross income, the appraiser deducts operating expenses. Generally accepted appraisal practice is to not deduct mortgage interest from operating expenses, since these vary greatly from property to property.

The appraiser determines the capitalization rate by analyzing sales (comparing net operating income to sale price) in the same market to determine rates of return. The capitalization rate will vary, depending on the attractiveness of a property as an investment, income risks and physical factors.

The Income Approach is used when appraising properties that produce a rental income from single or multiple tenants. The capitalized value of the income stream provides an estimate of the market value of the property (land and improvements).

For more information on the property appraisal process, contact your local BC Assessment area office or visit [www.bcassessment.ca](http://www.bcassessment.ca).