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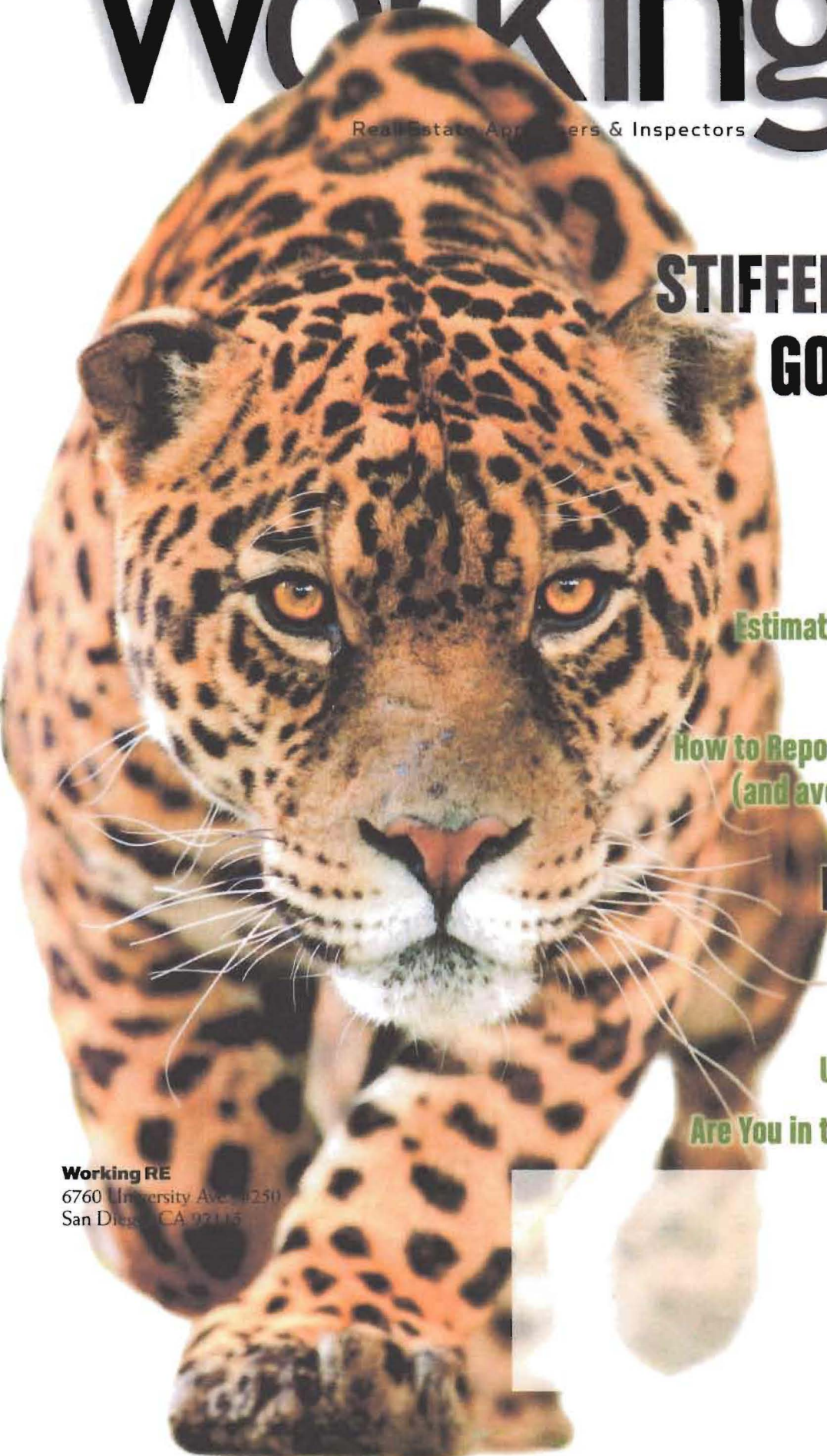
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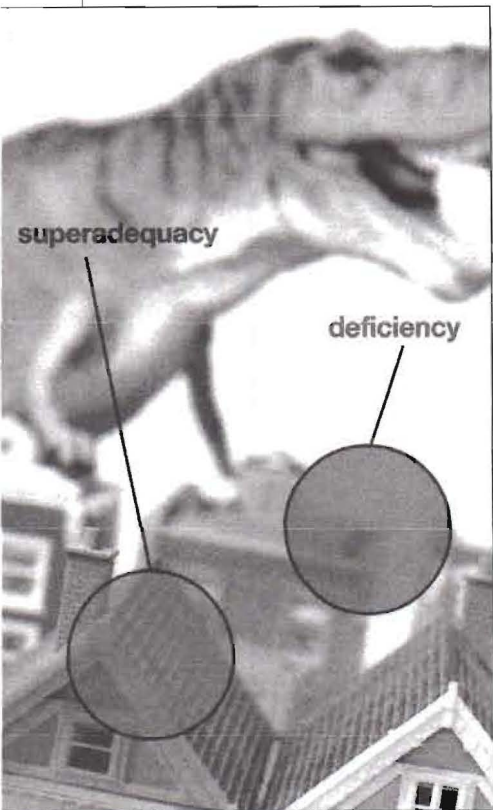
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Estimating Functional Obsolescence

by Philip G. Spool, ASA

Editor's Note: *Second of a three-part series on estimating physical deterioration (depreciation), functional obsolescence and external (locational and economic) obsolescence. Find part one, Estimating Physical Deterioration at WorkingRE.com, Library, Volume 32*

When was the last time you indicated a functional obsolescence in the cost approach? Did you also reflect it in the sales comparison approach? Would you? Should you? These are questions we rarely, if ever, consider. Perhaps we even avoid the issue when we think the house we are appraising has functional obsolescence.

In order to prepare for this article, I read and re-read many appraisal books regarding functional obsolescence and how it is determined. The more I read, the more I realized how complicated it can be. You will notice that some of my sentences end with a question mark (?). This is because functional obsolescence is probably the most complicated obsolescence to calculate mathematically, and so, I question whether it is really necessary to do any calculations at all. Here's what I mean.

What Is Functional Obsolescence?

According to the *Dictionary of Real Estate Appraisal, Fifth Edition* (Appraisal Institute), functional obsolescence is "the impairment of functional capacity of a property according to market tastes and standards." The Appraisal Institute's (AI) book *The Appraisal of Real Estate—Thirteenth Edition* states, "Functional obsolescence may be caused by a deficiency or a superadequacy. Some forms are curable and others are incurable."



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Does this mean that as appraisers we insert our interpretation and opinion as to whether a property has functional obsolescence or is it determined by the potential buyer of a property? In my opinion, the answer is yes to both. The potential buyer of a property ultimately determines whether or not a property has functional obsolescence. Also, any person with experience in the real estate market can possibly determine if the property has functional obsolescence by observation. However, determining the dollar amount of the obsolescence is another issue.

Types of Functional Obsolescence

Functional obsolescence is the result of defects within a property. This may be in the building, the building itself, or on the site but not in the building. It may be the result of a superadequacy or a deficiency. It may be curable or incurable. There are two types of functional obsolescence: *superadequacy* and *deficiency*. A superadequacy is something that exceeds what is typical for the properties in the area and does not contribute to the overall value in an amount equal to its cost. A deficiency is basically the lack of something that other properties in the subject's neighborhood have. A superadequacy or deficiency can be either curable or incurable.

Examples of Functional Obsolescence

A *superadequacy* can include an overimprovement to the structure. An example would be a house in a relatively new development that the builder used as a model, including many extra features that

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are not in other houses. It could be converting an adjoining bedroom for purposes of creating an oversized walk-in closet for the master bedroom or making it into one very large master bedroom—something that is not typical of the other houses in the area. There are many other examples. A superadequacy is typically associated with features that are above and beyond what is considered normal for the neighborhood.

A *deficiency* can be too few bathrooms given the number of bedrooms, or the lack of a bathroom that has easy access to a swimming pool (sometimes referred to as a cabana bathroom). It can be a house that has wall air conditioning units instead of central air. If a property requires an addition in order to be functional or if the property requires some form of modernization or renovation(s), such as a new kitchen, bathrooms or flooring, these are examples of a deficiency. What about a poor floor plan? An example of a poor floor plan is a bedroom that can only be accessed through another bedroom. More than likely this would be a deficiency. There are many other examples. A deficiency is associated with the lack of features that are associated with what is typical in the area.

Curable or Incurable

The key difference between curable and incurable functional obsolescence is whether the cost to cure results in an incremental increase in value. If it does it is considered curable. An example of curable functional obsolescence would be if renovating a kitchen would result in an increase in the overall value of the house greater than the cost to renovate the kitchen. Most curable functional obsolescence are deficiencies. An example of incurable functional obsolescence (deficiency) would be if the cost to add an additional bathroom exceeds the incremental value it would gain by adding it, especially if there is no space available for the additional bathroom. However, if adding the additional

bathroom generates more value than it costs, then it would be considered a curable functional obsolescence (deficiency). Think of a four-bedroom/one bath house versus a four-bedroom/two bath house as an example.

A superadequacy in a house may be an oversized swimming pool or a custom kitchen that is not typical of the neighborhood. The cost to cure would be the cost to remove the existing superadequacy (oversized swimming pool or the custom kitchen) and replacing it with a standard size swimming pool (typical 15' x 30') or a non-custom kitchen. Both of these are examples of an incurable functional obsolescence (superadequacy). It would be an extremely rare situation for a superadequacy to be curable—there are none that I know of. It is more likely that the sale of the house with a superadequacy would not generate an amount equal to what it cost.

Calculating Functional Obsolescence in Cost Approach

Regarding a *functional obsolescence deficiency that lacks something*, the calculation is the difference between the reproduction cost with the curable item and without it, as of the date of appraisal. Note that this is reproduction cost and not replacement cost. Functional obsolescence is the *excess cost* of adding the item in question, such as an additional bathroom or the new kitchen, to the existing house compared to what it would have cost at the time of construction. Since it is an added item, only the cost new is utilized. Regarding a *functional obsolescence deficiency that requires modernization* (kitchen, bathroom or flooring), the cost to cure is based on the same principle as above, with the exception that the depreciated cost of the existing item must be deducted as most likely it will not be salvageable.

Regarding a *functional obsolescence superadequacy* (most likely incurable), if the appraiser calculates the *replacement cost* in the cost approach, the functional obsolescence is eliminated. In regard

to the oversized swimming pool or a custom kitchen in a neighborhood not needing a custom kitchen, it would be the cost to eliminate or remove the existing item and replace it with an item considered acceptable for the area. But this would be ludicrous because unless the superadequacy causes additional expense (heating an oversized swimming pool for instance), the appraiser would not do any calculation for functional obsolescence—superadequacy. Again, if the appraiser considers replacement cost new of the swimming pool, it would be a typical size pool and not the oversized swimming pool.

An alternative approach to measure functional obsolescence would be to apply the rent loss difference between the house with the deficiency (i.e. the monthly rental rate of a four-bedroom/one bath house versus an acceptable four-bedroom/two bath house), and then apply the gross monthly rent multiplier to this rent loss, attributable specifically to this deficiency. This is also difficult to do but is certainly better than trying to perform a paired sales analysis to compute the functional obsolescence.

How Is Functional Obsolescence Treated in Sales Comparison Approach?

FannieMae Form 1004 has line items regarding Design, Quality of construction and Functional utility. An adjustment for any of these line items is difficult to determine. All textbooks lean toward using a paired sales analysis. This is easier said than done. *Design* is based on the style of the house, such as a one-story versus a two-story or a ranch house versus colonial or Mediterranean. This may be a matter of preference or taste, unless the subject's design is out of place for the neighborhood. A good example of this would be a two-story house in a predominately one-story neighborhood.

Note that *quality of construction* should not be confused with condition of the

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building. A good example of quality of construction is different roofing materials. A house with a slate or cement tile roof would probably be considered superior to an asphalt shingle roof. Sometimes the quality is based on the cost differential between the two materials, but again, in this situation, cost does not equate to a difference in value. *Functional utility* is probably the best location to place an adjustment for functional obsolescence, but how can it be quantified?

Calculating Functional Obsolescence in Sales Comparison Approach (or do you?)

Functional obsolescence as a form of depreciation is not calculated in the sales comparison approach, only in the cost approach. Functional obsolescence is "hidden" in adjustments in the sales comparison approach, such as outdated kitchens, bathrooms, old-style wallpaper and carpeting (remember shag carpets?). Line adjustments made in the sales comparison approach, for design, condition, etc. are, in essence, adjustments for functional obsolescence, but it is not referred to as such in the sales comparison approach. There is no line

item for poor floor plan, superadequacy or deficiency.

Even though calculating the functional obsolescence of the subject is plausible, the purpose of the sales comparison approach is to compare the subject with sales of properties similar to it; any difference between the subject and the comparable sales would reflect an adjustment. A comparable sale would reflect the functional obsolescence in its sales price.

Other than the obvious—such as too few bathrooms given the number of bedrooms (four-bedroom/one bath house), how would you know if the comparable sale has functional obsolescence unless you either appraised the property or have firsthand knowledge of it? Most likely you wouldn't. Design, quality of construction and functional utility, which was briefly discussed above as possible functional issues, cannot be determined in the comparable sale unless the appraiser has firsthand knowledge of that property. Any adjustment you intend to make regarding functional obsolescence to the comparables, in comparison to the subject, is almost impossible to support.

Instead of trying to calculate the amount of functional obsolescence in the sales comparison approach, consider going toward the lower end of the range in your adjusted sales price when reconciling and state why you went toward the lower end of the range. One explanation you can give is to recognize that, more than likely, functional obsolescence exists in your subject property which would make the comparable sales superior to the subject, but that quantitative adjustment is difficult to support; therefore, a market value closer to the lower end of the range would be considered appropriate.

In conclusion, if your subject property has functional obsolescence, an adjustment for it in the cost approach could be made and supported. But it is difficult and nearly impossible to support an adjustment for functional obsolescence in the sales comparison approach, as the only logical method to use would be the rent loss method. This would require rental comparables for the subject with the functional obsolescence compared to a rental without the functional obsolescence—a near impossibility. **WRE**

One Simple Step to Avoid Putting Your E&O Coverage in Jeopardy

by David Brauner, Senior Broker at OREP

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