Valuers: Value Inventors or Assessors

Jonathan AYITTEY, Frank GYAMFI-YEBOAH and Anthony GAMBRAH, Ghana

SUMMARY

Some consider valuers to be magicians inventing values of properties. Valuation is generally said to be "an art rather than a science". Because of the imperfection of the property market, value is always imprecise and subject to a degree of uncertainty and valuation. Not withstanding all these, it is argued in this paper that, the art of valuation is a process of an assessment and not an invention. Before a valuer comes in, there already exist a value determined by market variables and players. All that a valuer does is to gather, synthesise, analyse existing data and trends to estimate the possible market price. The traditional methods of assessing value were reviewed to substantiate the assertion that valuation is an assessment rather than an invention.

A significant part of risk management within the banking sector is property valuation when it comes to lending. Value estimates are heavily relied on by clients. The "accuracy" of value and comprehensiveness of valuation reports are crucial tools in investment decision making. Valuers in West Africa have a role to play in protecting their various economies from mispricing and price formations which are at high degree of variance from market indications.

The thesis of this paper is, by adhering to tested and accepted techniques and underlying concepts, valuers in Ghana and the Sub-region will act as assessors rather than inventors of value.

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1. INTRODUCTION

A valuer's work is said to be "an art not a science". The methods/techniques used in arriving at that "magic number (Aluko et al, 2004) makes the valuation more of an art. However the underlying theme/concept of valuation is more of a science rather than an art. The output figure depends much on a lot of a variables, which for this paper, are referred to as input information. Since the input information will be affected by uncertainties, value estimate is subject, to a high degree of uncertainty. The accuracy then of valuation becomes very subjective and at times creates doubt in the mind of clients and the public. The Valuer is not to blame for valuation uncertainties, the valuation can only be certain if we can accurately predict the future. Because this is not possible, a degree of uncertainty is acceptable in valuation. (French & Gabrielli 2003).

The thesis of the paper is that uncertainty and variance in valuation are real and universal. But to help clients and enhance the credibility of our work as valuers, the degree of uncertainty can be limited if we move from value "invention to assessment". Clients will tilt towards taking our output figure as an assessment rather than invention if we endeavor to clearly account for uncertainties in the valuation and report same in an effective manner.

Some clients consider the valuation to be a guess work and find it difficult to understand the source of variance in the output figure of two different valuers' opinion on the same subject property. Uncertainty and variance in valuation cannot be eliminated, yet identifying the sources of these and trying to limit and clarify these will make valuation an assessment and not an invention. The valuer is expected to be an interpreter of market variables that impact on the value/price of properties. In doing this, he/she faces a lot of uncertainties, which impact on the product. Whiles much cannot be done to make the valuers work a physical science, following standards, procedures, concepts and more importantly guidance notes of the professional body, can help clients to a large extent and build confidence in the valuation figure. A discussion of the process and methods will elucidate this assertion.

2. THE VALUATION PROCESS AND METHODS

Valuation in the property market is said to be the best *estimate* of the trading price of a property. A lot of literature exist that at various periods define what valuation is all about. Ratcliff, Grasskamp, Ely, McParland, McGreal and Peto are just a few that have extensively defined and expatiated on the language of valuation. Ratcliff (1975) identified three capital values; subjective, market and price. All these shades of value figures impact on the work of a valuer. As observed from the RICS Manual of Valuation and Appraisal (1996), Subjective Value to the owner of property, the Market Value and the Price at which a property is sold, form the bases of valuation.

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The valuer never attempts to invent the actual observable exchange price in the open market that will amount to invention, for that can not be possible. A valuer is trained to "estimate the price that would be achieved if the property were to be sold in the open/perfect market. It does not really involve calculating a specific occupiers/owners perception of the capital sum that he/ she would be ready to pay/accept for the various benefits that is expected to flow from the property. Valuers are interested in a rational investor in a perfect market. Such a hypothetical investor makes his investment decision considering the asking price and the present value of future stream of incomes predicted to be produced by the property. So are valuers just forecasters, predictors or as it were value inventors?
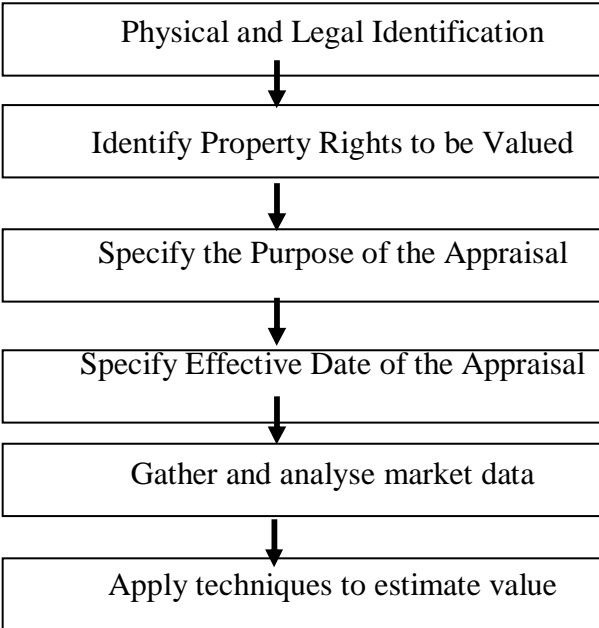
No! They follow processes and methods, and adhering to these make valuation as assessment rather than invention. For a fact, value exists before valuers come in, all valuers do is to interpret. What then is involved in the process?

3. THE PROCESS

In arriving at the estimate a systematic approach, at times, referred to as Appraisal Process is used.

Brueggeman and Fisher (2001) break down the entire process into six (6) main steps.
VALUATION PROCESS[1]

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┌─────────────────────────────────────────┐
│   Physical and Legal Identification      │
└─────────────────────────────────────────┘
                    ↓
┌─────────────────────────────────────────┐
│   Identify Property Rights to be Valued  │
└─────────────────────────────────────────┘
                    ↓
┌─────────────────────────────────────────┐
│   Specify the Purpose of the Appraisal   │
└─────────────────────────────────────────┘
                    ↓
┌─────────────────────────────────────────┐
│   Specify Effective Date of the Appraisal│
└─────────────────────────────────────────┘
                    ↓
┌─────────────────────────────────────────┐
│   Gather and analyse market data         │
└─────────────────────────────────────────┘
                    ↓
┌─────────────────────────────────────────┐
│   Apply techniques to estimate value     │
└─────────────────────────────────────────┘
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The clearly stated steps indicate that much is required of a seasoned valuer in his/her attempt to value a property. After clearly identifying the property legally and physically, a valuer is

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[1] Bruggeman and Fisher , (2001) Real Estate Finance and Investments pp 225

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expected to follow through by also isolating the right, which is the subject matter of the current estimate. Understanding this implies that "Capital Value", for instance, as a designation on most of valuation report fall short of identifying the right in the property being valued. Will it be more specific to say "Capital Value of 50 years Interest in Property No#? "

The third step in the process calls for identifying the specific purpose of the valuation. This is a crucial step since valuation for lending is different from one for insurance losses or property tax assessment. Next, a valuer agrees and specifies the effective day of the value estimate. Market variables are time related, they change over time, and it is therefore an essential part of the process to specify the effective date of the value estimate.

The fifth step – Gather and analyse market data – is the crust of the process. This is where, the skills, experience and knowledge of the valuer is very relevant. Considerable work has been done on the relevance of Market Data in the Valuation Process. (Aluko et all (2004), Ratcliff (1972, 1975) Fanning, Grisson and Pearson (1994), French (1997), Maes (1976), Mason (1985), Peto (1997) and Smolen & Hambleton (1997). This step calls for having a complete knowledge of the subject hereditament and the comparable to be used. Barlow (1985) reiterated that a conscious inspection of the subject property and its available comparables is an unavoidable step in the valuation process. The calibre of the inspection is crucial for choice of method and can make a difference in the quality of the valuation product. Beyond physical inspection of the subject property and its comparables, the valuer is expected to find out other market variables such as interest rates, inflation rates, level of frequency of property transactions, costs of construction, materials, among others, pertaining in the subject property's market or region. Aluko, Ajayi and Amidu (2004) also noted that since valuers are not only interested in land value but real property interest, externalities and other forces of demand and supply on the market value of the subject property being valued, must be well considered, analysed and interpreted.

There may be various sources from which a valuer may gather his/her information. He/she can resort to publications, government and parastalal institutions, private sources, public records, firm's own files, IT sources (Kinnarel 1971, Masson 1985, Aluko et al 2004) among others. But the process calls for much caution since not all information from these sources are good evidence. For a good assessment of value, market data used in valuation must be valid and authoritative. The relevance of diligent market data gathering and analysis can not be overemphasised. A necessary and essential step this is in distinguishing valuation as a value assessment rather than value invention. Lenders borrowers and investors use the valuers report to make lending and investment decisions. The quality of the value estimate and the entire valuation report depends to a large extent on the market data gathering and the quality of analysis carried out in the valuation process.

The final step in the process is, apply appropriate techniques/methods to derive the estimate value.

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4. METHODS/APPROACHES/TECHNIQUES

Valuation is the process of determining market value. The method used in estimating that value should therefore attempt to reflect how, buyers in the market would assess the worth of the asset and identify what probably will be the highest and best bid, French (1997). In determining market value, there are traditionally/conventionally three methods. (French and Bowman 1996; Peto 1997, Shimmon 1983, Baum, Crosby and Macgregor 1996). Namely: Sales/Market Comparison, Income Capitalisation and Cost method. Other less used methods are the Profit and Residual methods. The choice of any of these methods is to be informed by; purpose of the valuation exercise, availability of transactional data, location and nature of property, among others.

Recent development among experts in the field calls for more use of Discounted Cash Flow (DCF) Methodologies. (Mallinson Report 1994). The DCF Method is not expected to replace the traditional methods but can and should be used whenever the purpose calls for worth calculation. French (1996) emphasised that DCF is not panacea to all valuation problems but instead should be used alongside the principal methods of valuation.

The choice of method is very important in the valuation exercise. Though there is no fast rule on the choice currently, to help clients make an informed decision using value estimates, a professional valuer is expected to display enormous care and caution. This way the value is more of an assessment rather than an invention of value which hitherto was not in existence. Brett (1990) is in good company when he asked "how safe are we with valuation estimates?" Estimates can lie far away from the normal distribution of 100% interval if a wrong method or even basis is adopted in the process. This is beyond the classification of optimistic or pessimistic valuation. Among other factors, the choice of method for a particular valuation can affect the value to a large extent hence the credibility of a professional valuer. As reported by Brett (1990), David Hagar decided at a point to test the accuracy of valuation estimates. He selected two investment properties and got an initial (control) value from a valuer. He then let loose on the properties to nine other valuers. In one case their figures ranged from 13% below the control valuation to 7% above. In the other, the range was 25% below to 8% above. Admitted, valuation estimates are professional opinions and very subjective, yet a reasonable degree or range can be obtained if among other steps an appropriate method is adopted in the process.

To bring to the fore the essence of the choice of a method, we consider the essential aspects, briefly, of the three conventional methods used in establishing the market value of property.

5. SALES/MARKET COMPARISON METHODS

This method is based on data provided from recent sales of properties highly comparable to the subject property. The rational for the sales comparison approach lies in the principle that an informed investor would never pay more for a property than what other investors have recently paid for comparable properties. The valuer relies heavily on market data in using this method. He surveys, summarises and uses sales transaction data on comparable properties

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from the market area, analysed in the development of expected rents and value estimate for the subject property. Since no two properties are exactly same, the valuer must adjust for differences to arrive at a final value estimate.

Categories of adjustment are never exhaustive but must account for; time, finance, location, physical characteristics, conditions of sale among others. Adjustments should be made relative to the subject property being valued, the comparable data must be adjusted as though one wants to make the comparable identical to the subject property. This aspect of the comparison method is subjective, but as professionals, such adjustments should be justified with evidence based on recent experience with highly comparable properties, else, serious errors can result (Brueggeman and Fisher, 2001). In fact all the valuer is attempting to do is to answer the question, what would the comparable have sold for if it were like the subject property?

Though the sales comparison method is claimed to be the best estimate of the market value, its use is limited to a large extent, especially in developing economies. Inadequate comparable sales data, the unstable market condition and the fact that, it is based on past prices and trends, make the use of this method very seldom in our nation (Ghana). To the extent that sales are lacking or the data used by the valuers are inadequate, the assessment of the value of the subject property under current market conditions is limited.

Scarcely do valuers use the market data approach in developing nations, as already stated. Yet if we are to perform as professional assessors of value then much effort must be put in. Uncertainty can not be eliminated in Valuation. But as indicated by Mallinson and French (2000) measuring and reporting such uncertainties in a clear and straight forward term will greatly inform and aid client in their decision making. This way, valuers can protect their credibility and act as real assessors but not inventors of value.

Admitted, there are problems associated with the uncertainty of market data for the sales comparison method, yet established in Valuation circles is that, a seasoned and knowledgeable valuer must be a competent market analyst to have access to relevant information both in terms of quantity and quality. A seasoned Estate Surveyor must be able to act effectively as a market analyst and a consumer researcher. Valuers who fail to research the market, understand past market behaviour and to estimate changes in future real estate cycles may therefore make valuation products an invention and figures that are sub optional, if not dangerous (Aluko 2004).

6. THE COST APPROACH

The argument is that no investor would be willing to pay more for a property than the cost of building a property of equal utility. The basic concept, therefore, on which the cost method relies, is the principle of substitution. This method is very relevant to the investor who is considering a new project.

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In the use of this method, the value of the property is determined by first reckoning the current cost of replacing/reproducing the development. Next, estimate the loss in value (depreciation) caused by physical deterioration, functional deficiencies and adverse economic influences. The assessor then deducts accrued depreciation from the development's reproduction cost (DRC). The process then calls for the estimation of the land (site) value as if vacant. Adding land value to the depreciated replacement cost estimate results in the value estimate.

The above seems very simple and straight forward. No wonder, most valuers in the West African region easily resort to this approach, but as indicated by Jaffe & Sirmans (1995), the cost method is probably the most difficult of the three methods to apply accurately.

It should mainly be used in situations in which data is lacking for the market comparison and income approaches. Special–use properties like churches, public building and museums are but valued in this manner because the other approaches are somewhat inapplicable.

While the hard cost elements of construction, such as; excavation – back fill, foundation, floor, finishes, brick/block work and etc, are easily and objectively obtainable, a lot of subjectivity comes in when it comes to the soft cost elements. The valuer relies on either his/her experience and judgement or a qualified builder, to estimate cost such as construction interest, developers' profit, leasing commissions and others. Another area where subjectivity can greatly affect the value estimate is the calculation of accrued depreciation. This loss in value is commonly measured by the straight-line and the breakdown methods. Identification of the various forms of depreciation is a major problem, but proper measurement of the depreciation is an even greater shortcoming of the cost approach. Since the depreciation level is the loss in value between a new and a used structure, and because the estimation of depreciation is highly subjective, the method is open to substantial error.

Over reliance on this method thus may not be appropriate and "accurate" in assessing open market value (OMV). It can lead to reporting value which really is not in existence or capable of existing in the market. The assumption that cost less depreciation is equal to value, does not always hold. For instance, if the development does not make the best use of the site or if market demand is in equilibrium and additional properties of a particular type are not required at the time of valuation, OMV will be less than cost. The opposite can also be at times real, even with newly developed properties.

The above discussion does not imply that the method is outmoded or should not be used in assessing OMV, rather it must not be over relied on. However, it is worth noting that a school of thought in the valuation arena remains questioning the use of the cost approach. Marchitelli (1992) for instance suggested that the method be abandoned in the valuation process in most situations.

For instance in making "build –versus- buy" decision, determining the feasibility of a renovation, Jaffe & Sirmans (1995) recommends the cost approach. The caution however is

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that over reliance on it can lead to dangerous invention of value which is far below or above what should be "possible" Market Value.

7. INCOME CAPITALISATION APPROACH

Value is at times defined as the present worth of the expected future stream of income received from ownership of property. This definition forms the basis of the Income Approach in property valuation. The principle here is that the value of a property is related to its ability to produce cash flow. The technique relies heavily on current market transactions involving the sale of comparable properties. Using this method the valuer defines value us

$$V = I/R$$

Where   V = Value,   I = Expected Income Stream

                  R = Rate of Capitalisation.

The expected income stream is the net income the subject property is currently generating or the net expected stream of income obtainable and its pattern for the estimated remaining economic life of the property.

Once again the professional competence of a valuer is brought to the fore. Estimating the net operating income (NOI) is not a guess or an invention assignment. It calls on the valuer to use his training to

– Estimate latent/potential gross income
– Estimate and deduct vacancy and bad debt loss allowance to derive effective gross income
– Estimate and deduct expenses of operation to derive net operating income
– Estimate the unexpired term/economic life and pattern of the projected income stream

After arriving at the NOI/Potential NOI, the valuer is expected to work out or select an appropriate yield/discount rate. Depending on the capitalisation techniques adopted (Direct Capitalisation, Discounted Present Value and Gross Income Multiplier), the appropriate rate must be derived. Economic life and pattern of the income stream should be considered before selecting a capitalisation method.

The valuer can use any of the three conventional methods to derive the discounting rate;

– Using recent sales data on similar properties
– Using bond of investment/mortgage-equity analysis or
– Ell-Wood technique.

When using the sales data, the valuer makes sure of using data on only highly similar properties in terms of age, location, quality, condition and other relevant factors. While the mathematical derivation of these methods of discount rate is beyond our present discussion, it indicates that a lot is involved in using the income capitalisation method to estimate value.

The income method can be best applied to income generating properties. It is also easily adjustable to reflect changes in market factors, compared to the comparison and cost methods. Yet the method's application is limited in the case of properties that do not produce income for example churches. Another difficulty associated with the method is the development of an appropriate 'discount' rate. This introduces a level of subjectivity into the capitalisation method.

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8. DISCUSSION

Consideration of these principal methods used by valuers to arrive at value indicates that the process falls short of an invention but rather an assessment of what is existing or at least latent in a property. No matter the approach adopted, the exercise calls for gathering of enormous market data, analysis and synthesising of same before an opinion is expressed on value.

Are Valuers Value Inventors or Assessors? To invent implies to, create, make up, come up with, dream up, originate or even fabricate. On the other hand to assess denotes, to judge the worth, estimate, appraise, compute, determine, evaluate, weigh and very appropriately to value. Following the rules and ethics of the profession, a valuer must convince himself/herself that he/she is doing an assessment but not inventing. Value is found in the market place and not in the head or at the whim of a valuer.

A prerequisite in the assessment of value is the use of reliable market data. Aluko (2004) indicated that data are the driving force that fuel better valuation. He advocates the development of historical data series or centralised database by estate surveying and valuation firms in Nigeria. He acknowledged that one main problem facing valuers in his country is the collection of representative data giving a clear indication of market activity. The situation is not different in Ghana. What is the quality of value that valuers estimate in this data trap region? No wonder, a lot of valuation is carried out using cost method.

Several works have been done emphasising the fact that the accuracy and reliability of value estimate is directly related to the availability and proper interpretation of Market Data See, for example Waldy, 1977, Ratcliff, 1975, French, 1997, Fanning et al, 1994 and Peto, 1997. It is common knowledge that one of the characteristics of the property market is dearth of information resulting in a lot of valuations being carried out without adequate information. But it is due to this lack of accurate data, that a valuer's judgment is required in property transactions. It is therefore expected of a valuer to endeavour to search for, and keep record of any market information that may be available. Herd and Lizieri (1994) identified some of the implications of inaccurate valuations. Among other things inventing property value may constrain property analysis performance. Since the estimates are subject to a high degree of uncertainty, clients, especially investors depending on value estimates are subject to a lot of danger. Property indices also become unreliable. Another adverse effect of value invention is the valuers' significance. Is the profession suited to estimate value at all? As an art, exact or "accurate" figures are not expected, but clients, however expect a degree of accuracy. Valuation estimates are expected to be price representative. How meaningful then are invented figures if their accuracy can not be defined and have no bases. Professional advice is useless and the credibility of a valuer will have to be questioned. It is expected that valuation figures proxy objectives sales prices of a realties.

As Mallinson report indicated, there are a lot of shortcomings of the traditional methods valuers currently use. Yet endeavouring to search for and critically analyse adequate data before bringing out the "magic figure" (Aluko, Ajayi & Amidu 2004) will mean assessment

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rather than invention. The process used in determining value must among other things, withstand scrutiny and be logically comprehensible. (Peto *et al* 1996). For valuation figures to be really assessment then they must reflect the thought process of clients. At any rate, the figures should be crude indicators of the likely selling price of the market.

Assessment, rather than invention in valuation must be based on market evidence, after all valuation is said to be the estimate of the most likely selling price, an estimation of the price of exchange in the marketplace. There is never a single accurate way to estimate the expected market price than the process of a detailed comprehensive data analysis. About approach, none is problem free, yet to assess rather than invent, valuers must be very open about their valuations and level of uncertainties relating to estimated figures.

9. CONCLUSION

Valuers can influence the prices that are finally agreed on in the market, yet they should not be seen as "price" / value inventors. The sole use of traditional methods can have a substantial influence on the price, yet the effective use of adequate information can mimic an explicit valuation rather than value formation. Having gone through all that it entails to produce property value, the answer to the question "Valuers – Value Assessors or Inventors"? is very obvious. Following through, the process is a clear assessment procedure and not a creation or an invention. However, a private valuer must excel him/her self as an assessor in the eyes of his/her client. The ways of improving the process of valuation have been written on by many. (See for instance Fisher et al 1999, Smolen and Hambleton 1997, Peto, French and Bowman 1996, Mallinson and French 2000 and Crosby, Devaney and Matysiak 2003). There is no other alternative way out but to be diligent and follow through tested and recognised laid down standards and procedures.

In assessing Market Value, the approach should express the thought process of the players in the market. Since the market is very uncertain, assessment of value is a process involving managing and reporting probabilities. Assessment instead of invention is a production of the most probable market price. To do this genuinely and avoid value invention, we recommend the following:
- An increase in the use of the sales comparison approach in most cases, especially when it comes to price/value assessment. Capitalization should be mainly used for worth assessment whilst cost method is rarely resorted to.
- A shift toward modern/DCF techniques but not complete closure to the traditional methods. A collaborative approach will be ideal
- More and comprehensive information need to be given to clients the valuation exercise. The process and levels of uncertainty hidden in the figures must be made known to clients.
- At least two methods should be used in estimating value and the result must be expressed as a range of possible obtainable figures. If possible such range of figures should be accompanied by probabilities. As much as possible valuation reports should be very comprehensive.

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The public rely so much on the expertise of a professional valuer, yet they do at times question our figures. To build confidence in the profession, lets be value estimators/assessors rather than inventors.

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CONTACTS

Jonathan Ayittey
Department of Land Economy
KNUST
Kumasi
GHANA
Tel. + 233 243 258 434/ + 233 208 127 913
Fax + 233 51 63673
Email: jonathanzinzi@yahoo.com

Frank Gyamfi-Yeboah
GHANA
Tel. + 233 244987180
Email: frankgyamfi2002@yahoo.com

Anthony Gambrah
GHANA
Tel. + 233 208 116 124
Email: antonygambrah@yahoo.co.uk

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