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THE QUALITY OF THE REAL ESTATE VALUATION PROCESS

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Abstract: For each market participant, knowing the value of the assets they manage is very important. Real estate is an essential group of such assets. Knowing their value determines the economic efficiency of decisions made on the real estate market. Real estate valuation is complex because the market is not transparent and is characterised by low information efficiency. The study hypothesised that it is possible to model risk in the real estate valuation process. The aim of the article is to identify and escribe the areas and sources of risk occurring in Polish valuation practice. A mixed research approach was used: literature research, questionnaire research and qualitative inference methods.
Keywords: quality, real estate, appraisal, process.

1. INTRODUCTION

All economic goods have value. From an economic point of view, the value of a given good results primarily from two of its features, i.e. utility or the possibility of exchange for another good. The external manifestation of value is price. It should be emphasised that value and price are two different economic categories, although inextricably linked. Price is the amount of money that a given buyer is willing to pay for a given good at a given time and that the seller is willing to accept. If there is a sufficient number of transactions on the market for a given good and the terms of these transactions are known, then the value of this good can be estimated. The direct effect is as follows: the greater the number of transactions and the better the information about the terms of the transaction, the more accurate the value estimate.

When the market is perfect, the price reflects the value of a given good. The real estate market is characterised by low transparency and low information efficiency. Low transparency results from difficulty in accessing information about real estate prices and transaction conditions. Low efficiency results from real estate prices not fully and immediately carrying and transmitting market information.

The more efficient the market, the closer prices match the value - and the smaller the price range for the same goods (Wrzosek, 2002; Bryx, 2006). Low market efficiency is a consequence of difficult access to information about transactions on the real estate market. In many countries, there are no public central registers of real estate transaction prices. Additionally, a large number of types of real estate and the functions they perform

make any market comparisons difficult. All of these aspects cause a greater valuation risk than in the case of other goods. The research problem undertaken in this study is very important because knowledge of the value of goods determines the economic efficiency of the transaction and its rationality. In some cases, it even determines the sense of such a decision.

The hypothesis formulated for the purposes of this study assumes that it is possible to model risk in the real estate valuation process. The aim of the article is to identify and describe the areas and sources of risk occurring in Polish valuation practice.

2. THEORETICAL BACKGROUND

Value is a central economic category. It was studied by representatives of classical economics, including Adam Smith, David Ricardo, Jean-Baptiste Say and John Stuart Mill, and neoclassical economics: William Stanley Jevons, Carl Menger. Further development of the concept is primarily associated with Léon Walras and Alfred Marshall. All of these researchers studied value because it has an important place in socio-economic relations. Knowledge of value determines whether the decisions made regarding transactions are beneficial or not (Zadora, 2004; Skodlarski, 2008.

Smith distinguished between use value and exchange value. The use value of a good is derived from its utilitarian characteristics. Exchangeable value, on the other hand, is the ability of a good to be exchanged for another good. Smith pointed out that price is a monetary representation of value. Value is also related to the quantity of a given good in the market and the quantity of money in that market.

Ricardo tried to explain value from the supply side. He assumed that value depends on the amount of work necessary to produce a good and not on the remuneration paid for the work. He emphasised that in order for a good to gain value on the market, there must be demand for it. The source of value of goods for which there is demand is scarcity, as well as the amount of work needed to produce it. His theory of land rent became the starting point of the law of diminishing productivity of production factors (Źróbek-Różańska and Źróbek, 2008).

J.-B. Say argued that the basis of a good's value is utility. He rejected the labour theory of value. J.S. Mill also rejected it. Instead, he developed a theory based on production costs. He was the first to emphasise the crucial importance of supply and demand in determining market value (Mill, 1965).

Jevons and Menger independently concluded that the value of not all goods can be explained on the basis of a theory based on the cost of production. This also applies to land. They saw value in the utility of land. They focused their attention on the demand side. Menger's great contribution to the theory of value is the statement that the value of a good is determined by the subjective point of view of the individual. Value ceases to be subjective when it begins to reflect the perceptions of market participants. Market value is created by constantly changing subjective values, which translates into constantly changing market value (McKnight, 1994).

Walras rejected the simple relationship between production costs and value. He pointed to the connections between the utility of a good, the final price of a good and the prices of production factors. He believed that the sole cause of value cannot be attributed to any of these factors (Landreth, Colander, 2005). Marshal had a similar position. He believed that the representatives of the classical school made value too dependent on

supply factors and the representatives of the neoclassical school on demand factors. In his opinion, the most important factor here is time. The shorter the period, the greater the role of demand; the longer the period, the greater the role of supply (Kucharska-Stasiak, 2012).

The theoretical considerations cited above were necessary to understand the category of value, which is the central category of the valuation process. Failure to understand the essence of this category is associated with the risk of incorrectly determining the value.

Valuation is the process of arriving at a value. Depending on the valuation assumptions, in particular the subject of valuation, the purpose and scope, and its intended use, the same property may assume different values. In addition, valuation practices vary in different countries (Kucharska-Stasiak, 2016). However, as a result of pressure from global investors, developers, lenders, and other stakeholders, valuation regulations are becoming uniform on a global scale. The standardisation process has involved institutions such as the International Valuation Standards Council[1] (IVSC, 2022), The European Group of Valuers Associations[2] – (TEGoVA, 2020), Royal Institution of Chartered Surveyors[3] (RICS, 2024). Despite standardisation, there are still differences in the regulations of individual countries. However, there are certain elements that are universal in nature. This study attempts to identify and discuss them using the example of conditions prevailing in Poland.

In Poland, the profession of a property valuer is regulated by law (*Ustawa…,* 1997; *Rozporządzenie…,* 2023) and professional standards for property valuers issued by The Polish Federation of Valuers' Associations[4] (PFVA). A valuer can be a person with appropriate authorisations granted by the relevant minister. This person must meet the conditions specified in the act. They concern education, specialist knowledge and professional practice. It is also necessary to pass an appropriate exam in theoretical and practical knowledge.

In Polish conditions, real estate valuation must be made in written form. This is the so-called valuation report (Wilkowska-Kołakowska, 2010). The report must contain information necessary for performing the valuation, including indicating the legal basis and conditions of the actions performed, providing substantive solutions, presenting the course of calculations, and containing the final result in the form of a number. The principles of using various approaches, methods and valuation techniques, as well as methods of determining value for various purposes have also been regulated.

The right approach, method, and valuation technique are selected based on many elements. These include the purpose of valuation, type and location of the property, its purpose according to local law, equipment of technical infrastructure (media) and development. Available data on prices, income and characteristics of similar properties are also important. In Polish valuation practice, the following approaches are distinguished:

- comparative,
- income,
- cost,

[1] https://www.ivsc.org
[2] https://tegova.org
[3] https://www.rics.org
[4] https://www.pfsrm.pl

- mixed.

The comparative approach involves determining the value of real estate based on comparisons with similar real estates that were the subject of market transactions. The income approach is based on the assumption that a potential buyer of the valued real estate will pay a price for it, which is dependent on the potential income from the property. The cost approach assumes that the property is worth as much as the costs of its replacement or reconstruction, taking into account its current level of wear and tear. The mixed approach allows for the use of various approaches listed.

The comparative approach uses methods such as pairwise comparison, average price correction and statistical analysis of the market. The income approach employs investment and profit methods. In the case of each of these methods, one of the following techniques can be used: simple capitalisation or discounting of income streams. In the cost approach, the reconstruction cost and replacement cost methods are used. Each of the methods is supported by one of the techniques: indicator, integrated elements, detailed.

Market value is determined using the comparative, income, and mixed approach. The cost approach allows for determining the so-called reconstruction value. Market value is of the greatest importance in a market economy (Kucharska-Stasiak, 2016). It is an estimated amount that can be obtained for the property if special transaction conditions do not occur (e.g. forced sale).

Valuation is a process that consists of elements that can be distinguished in each valuation. A typical valuation process consists of the following elements (*Rozporządzenie*…, 2023):

- identification of the valuation subject (what is being valued), the valuation scope (what rights are being valued) and the purpose of the valuation,
- determination of the dates for which the property condition is being valued and the market condition dates,
- conducting the real estate inspection,
- determining the purpose of the property (as recorded in local law),
- analysis and assessment of the property condition,
- analysis of the relevant property market,
- selection of the appropriate valuation method,
- conducting the estimation procedure,
- analysis and justification of the valuation result.

There are certain risks at all of these stages that can cause errors in valuation.

3. METHODOLOGY OF RESEARCH

In order to achieve the research objective and confirm or falsify the research hypothesis, a mixed research approach was used. Both qualitative and quantitative approaches were used.

The research process began with an analysis of the literature on value categories and the valuation process. A research gap was found in the form of an insufficient study of risk factors in the real estate valuation process in Polish conditions. This allowed the formulation of preliminary research assumptions. Further research focused on the

analysis of scattered sources on the practical aspects of valuation, taking into account the issue of valuation risk.

The research primarily focused on industry literature, industry websites, internet forums and other sources related to this topic. Valuation reports prepared by property valuers were also analysed. Own experience was also used (the author is a real estate valuer).

The next step was to construct a survey questionnaire. At this stage, scientific inference methods were used, mainly analysis and synthesis. The work began with a standardised interview with several appraisers in order to identify possible errors and inaccuracies and eliminate the risk of misunderstanding the questions. The surveys were sent to 1,627 professionally active property valuers. The survey was completed by 131 people, i.e. 8% of the respondents. This study was conducted in 2019. The results of this research were published in the works (Kuraś, 2019; Kuraś, 2020). This study was the starting point for further work on a model approach to risk in the real estate valuation process. At the moment, it is treated as a pilot study and will be repeated in a refined, extended form in the near future. During the analysis of the data obtained from the survey questionnaires, scientific inference methods were used, mainly analysis and synthesis. Due to the nature, scope and purpose of the study, the analysis was exclusively qualitative.

4. RESULTS AND DISCUSSION

The result of the research described in the previous chapter is a model approach to risk in the real estate valuation process. All risk factors occurring in the real estate valuation process can be divided into two groups. The first group consists of factors related to the identification of the subject and the scope of valuation. The real estate appraiser has no influence on them. The second group consists of factors related to the valuation procedure. The appraiser has full or partial influence on these factors. Therefore, they can manage them (Kuraś, 2020). Within each of these risk factor groups, risk areas and risk sources were distinguished. All these elements and their detailed description are included in the model in Table 1.

Table 1
Most significant risk factors in the process of real estate appraisal

Risk factors	Risk area	Risk source
Factors related to the identification of the object and scope of valuation (independent of the valuer)	Information in public real estate information resources	Information in land and building registers (geodetic information)
		Information contained in court registers (information on legal status)
		Information contained in the local law of local government units (information on the designation of real estate)
	Analysis of the real estate market	Sources of data and information about the market
	Pressure to distort the valuation result	Ordering party requesting or suggesting an over- or understatement of the valuation result
Factors relating to the estimation procedure (totally or partially	Inspection of the property	Intentional lack of inspection or inability to carry out the inspection on the date(s) relevant to the valuation or inspection carried out unreliably
	Determination of dates relevant to the valuation	Failure to understand or take into account special provisions (especially for rare cases)

dependent on the valuer)	Formulating valuation assumptions	Incorrectly carried out analysis process and/or and defects in reasoning logic
	Choice of approach, method and techniques of valuation	Incorrectly conducted process of choosing the method of valuation due to incorrect determination of elements such as object, purpose, scope of valuation, purpose of the property
	Degree of difficulty of the estimation procedure	Complicated property or complicated valuation
	Selection of comparative properties	Difficulty in obtaining data, quality of market information
	Determination of income losses from real estate	Lack of objective market data or difficulty in obtaining such data (e.g. on vacancy and rent arrears for the income approach)
	Determination of rates of return	

Source: Kuraś, 2020.

In the group of risk factors independent of the valuer, a significant risk area is information in public resources about real estate. Sources of risk are geodetic and court registers. Another significant risk area is the analysis of the real estate market. Among the sources of such risk is the quality of data information about the market. The last risk area in this group of factors is the pressure to distort the valuation result. The source of the valuation is the ordering party, who expects the valuation result to be overstated or understated.
In the group of risk factors wholly or partially dependent on the appraiser, a significant risk area is real estate inspection. The source of risk may be the intentional lack of inspection or inspection carried out unreliably. Another risk area is the incorrect adoption of dates, which are important for valuation. In this case, the source of risk is the failure to take into account or understand legal regulations. Another area of risk is formulating valuation assumptions. The source of risk is an incorrectly conducted analysis process. The degree of difficulty of the valuation procedure is another area of risk. The source of risk, in this case, is complicated real estate or complicated valuation. Another area of risk is the selection of comparable properties. The source of risk is the difficulty in obtaining data. Other risk areas concern income-generating properties. In this case, the most important ones are determining losses in real estate income and determining rates of return. The source of risk is primarily the lack of objective market data and difficulties in obtaining it.

3. CONCLUSION

The article presents the author's risk model in the real estate valuation process. Based on literature research, legal regulations, professional standards, interviews with property valuers, and the author's own professional experience, an attempt was made to identify the most important risk factors related to valuation. All these factors can be divided into factors independent of the property valuer and those that are completely or partially dependent on them. Within each of these factors, risk areas and sources of risk were distinguished.
Such a model approach allows for the organisation of valuation risk factors and its synthetic approach. This model is constantly being improved and expanded. In the near

future, further studies are planned on a larger group of property valuers. This future study will include an attempt to detect correlations between different variables. That is the element that is missing in the studies presented here.

Undoubtedly, such a model approach to risk in the valuation process allows for more effective risk management. This model is a starting point for risk management, as it significantly facilitates the identification of risk factors, their areas and sources. First of all, it reduces the risk of not considering the elements described in the study. This model probably did not take into account all risk factors. In this sense, it is not a closed list of risk factors. The study was conducted among Polish property valuers. Due to the increasing degree of standardisation of valuation processes in the world, this study is largely universal in nature. Therefore, researchers from other countries can use it as a starting point for their own research.

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