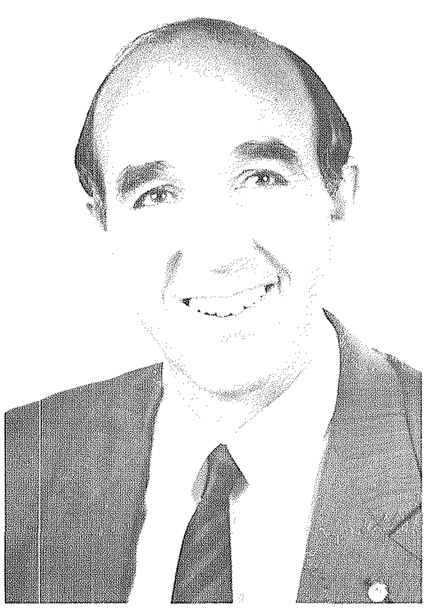
WHY PROPERTY VALUATIONS VARY

DIFFERENT ANSWERS? THEY MAY BOTH BE RIGHT



by CRAIG MILLER

Setting a value on real estate or other property is a challenge for valuers, who must take various indefinite factors into account – and who often must take legal responsibility for their opinions.

The process of valuation, whether applied to real estate or some other form of property, is, by definition, an inexact science. A valuation is a statement of opinion of the worth of a certain property and differences in opinion are inevitable. While valuers accept this as a professional reality, it is important to understand why opinions are likely to vary and what should be regarded as a permissible margin of error.

Valuers' opinions will vary for one or more of the following reasons:

- exercise of professional judgment;
- different instructions; or
- mistake or negligence.

I will deal only with the first two reasons because almost all variations will fall into one of these groups.

Exercise of professional judgment

The process of valuation requires an inspection of the property, consideration of all relevant information, an analysis of comparable sales and an understanding the market for the class of property. Some valuations are quite straightforward; for example, the valuation of a home unit in a block where a number of sales of similar units have recently taken place.

Most valuations, however, require the valuer to interpret sales of properties which are not identical or similar, but are only comparable in order to form an opinion about value. While sales analysis can be a sophisticated process, often carried out with computer assistance, the weight to be given to the results of comparisons is, in the end, a matter for the valuer's judgment.

The limits of permissible variation in valuers' opinions are often set at between 5 per cent and 10 per cent. I believe it is wrong to lay down firm rules about this. This margin will vary depending on the type of property, the number of comparable sales and the market. Narrow margins apply where there are a large number of sales of comparable properties. Wider margins can be professionally acceptable where the property is unusual, where there is a paucity of comparable sales or where the market is small or volatile.

In many cases, valuations are not tested against a market transaction, but there will be occasions where a sale of the subject property, within an appropriate period, may show a variation from the valuer's opinion. Watkins J in *Singer & Friedlander Ltd v John D Wood & Co* (1977) 26 The Valuer 400 at 401 said:

"The valuation of land by trained, competent and careful professional men is a task which rarely, if ever, permits a precise conclusion. Often beyond certain well-founded facts so many imponderables confront the valuer that he is obliged to proceed on the basis of assumptions. Therefore, he cannot be faulted for achieving a result which does not admit of some degree of error. Thus, two able and experienced men, each confronted with the same task, might

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come to different conclusions without anyone being justified in saying that either of them has lacked competence and reasonable care, still less integrity, in doing his work."

His Honour went on to say: "Any valuation falling outside (of the permissible margin) brings into question the competence of the valuer and the sort of care he gave to the task of valuation."

Accordingly, the valuer will not be negligent simply because he was wrong, provided that his valuation falls within what is, in the particular circumstances, the permissible margin of error.

Different instructions

Only 30 years ago a valuation theory – "one value for all purposes" – was still being advocated by a large number of valuers and academics. Using this theory, it was necessary only to instruct a valuer to value the property. There are many reasons why such a simple approach to valuation has no validity today.

Most valuations are carried out because there is a need for an authoritative statement about the market value of the property. Market value has been described as the "value in exchange". This short, simple definition has been expanded in a number of court judgments, both in Australia and overseas. The judgment of Isaacs J in *Spencer v The Commonwealth* (1907) 5 C.L.R. 418 is regarded as a landmark decision in valuation practice. At p440 the judgment reads:

"To arrive at the value of the land at that date, we have, as I conceive, to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser, willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land, and cognisant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to convenience or inconveniences, its surrounding features, the then present value deemed for land, and the likelihood, as then appearing to persons best capable of forming an opinion, of a rise or fall for what reason soever in the amount which one would otherwise be willing to fix as the value of the property."

In addition, it should also be assumed that the property is to be sold for cash, or on terms reasonably equivalent to cash, and that the property will be given suitable marketing to attract buyers.

The market comprises many individuals, to some of whom the property may have a value discernably different from its market value.

Market value is a basic concept in valuation practice. It answers the question: "What can I expect to obtain for my property?" The limitation of the market value concept is that it treats the market as one amorphous mass of people, when the reality is that the market comprises many individuals, to some of whom the property may have a value which is discernably different from its market value. The need for differentiation may also arise from legislation or from contractural arrangements.

Accordingly, in accepting instructions, the valuer has a responsibility to answer the question: "Who wants to know the value of this property?" The answer may be an owner thinking of selling his property or an intending mortgagee. The owner wants to know what he can obtain for his property (in other words, its market value). The intending mortgagee, on the other hand, will also wish to know the market value – but viewed from his perspective, with any doubt in the valuer's opinion to be resolved against the property. Thus the market value of the property from the point of view of an intending mortgagee can be less than its market value from the perspective of its owner. There may also be occasions where an intending mortgagee specifically requires a valuation based on a forced or "fire" sale.

Sometimes a property may have a special value to its owner or to another party. Special value is a different concept from market value and the valuation process in determining such special value can be quite different from that of determining market value.

Special values can be present in all classes of property and can arise for a number of reasons. It may be the added value which an adjoining property has to an expanding manufacturer, or the value of a specialised facility, such as an abattoir, to a profitable meat company. Sometimes other names are used when special interest valuations are required, such as "in use", "going concern" or "replacement" value to the owner.

Depending on the property and its location, there can be a substantial difference between its market value and its special value. While the owner of a specialised facility might consider that its special value, based on the cost of its replacement, represents a proper asset value, a lender or investment analyst may be interested only in the market value of the property.

In preparing his valuation report, the valuer should set out his instructions, or the basis on which his valuation has been prepared, and any limitations imposed in those instructions. Anyone relying on the valuation will then clearly understand the approach and the valuation basis.

Instructions are also important in a rental valuation – is the rental being assessed on an open-market basis, or is it being assessed in accordance with the terms and conditions of the lease?

In my experience, differing instructions have been the main reasons for material variations in valuers' conclusions. The first step in undertaking a critical review of a valuation should be to understand thoroughly the instructions and any limitations to ensure that they comply with what was expected.

From the point of view of the valuer, a clear reflection of instructions and assumptions is important, as the valuer is not only liable for professional negligence in contract to his client, but also owes a duty of care to third parties, within reasonable limits, who may act on his valuation and subsequently suffer loss or damage. ☐