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BACHELOR THESIS

THE VALUATION PROCESS OF REAL ESTATE IN THE CZECH REPUBLIC

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I hereby declare that I have written this bachelor thesis called "The Valuation Process of Real Estate in the Czech Republic" independently and by myself using only the sources referenced in the Bibliography section at the end of this thesis.

April 30, 2009   Klára Rysková

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THE VALUATION PROCESS OF REAL ESTATE
IN THE CZECH REPUBLIC

OCEŇOVÁNÍ NEMOVITÉHO MAJETKU
V ČESKÉ REPUBLICE

Summary

This thesis examines the situation of property valuation and appraiser profession in the Czech Republic. The rapid changes in both real estate market and the local economy after the Velvet revolution of 1989 and the accession to the EU in 2004 and the resulting changes in legislation, created new demands for professionals dealing with real estate property. The central issue is the duplicity of appraiser profession in the Czech Republic. The Czech legislation recognizes two types of professional appraisers: (1) *Sworn-in appraisers* are appointed under the Act No. 36/1967 Coll. published by Ministry of Justice. As a rule, these experts largely deal with setting state-regulated administrative prices of property according to the Act No. 151/1997 Coll. and the Act No. 456/2008 Coll. and are additionally allowed to determine market value of a property. (2) *Appraisers and foreign experts* holding a "Trading licence" issued by the Ministry of Industry and Trade are generally guided by their own codes of practice and professional standards and are allowed to determine the market value only. In recent years, there has been much discussion about unified and enforceable valuation standards and ethics in the field of property valuation. Similarly, this discussion may be observed in the whole EU as the importance of establishing a common unified valuation platform becomes more and more obvious. Real estate form a significant part of the national wealth and it is therefore advisable to know their market value to bring more transparency into the market environment for needs of potential and foreign investors. Regarding this context, the thesis further concentrates on exploring the existence, extent, and impact of international valuation standards among professionals.

Keywords: valuer, valuation process, administrative price, market value, cost approach, sales comparison approach, income capitalization approach, international valuation standards

Souhrn

Bakalářská práce je zaměřena na analýzu oceňování nemovitostí a profese soudních znalců a odhadců v České republice. Prudké změny jak na realitním trhu, tak v ekonomickém vývoji země po revoluci v roce 1989, jakož i výsledné změny v legislativě, kladou nové požadavky na profesionály zabývající se oceňováním nemovitostí. Tuto profesi je možné vykonávat dvojím způsobem: (1) Jako znalec na základě zápisu do seznamu vedeného Ministerstvem spravedlnosti a v souladu se zák. č. 36/1967 Sb. Znalci jsou oprávněni stanovovat regulované administrativní ceny nemovitostí dle zák.č. 151/1997 Sb. a platné vyhl. č. 456/2008 Sb, které jsou využívány především pro výpočet daně z převodu nemovitostí, a dále i ceny obvyklé, tj. tržní. (2) Jako odhadce či zahraniční expert pracující na základě živnostenského oprávnění vydaného Ministerstvem průmyslu a obchodu. Tito odhadci jsou většinou vedení vlastními stanovami a mohou u nemovitostí stanovovat pouze cenu tržní, která se většinou používá v podnikatelské sféře. V posledních letech byla obnovena diskuse zabývající se tématem jednotných a vynutitelných oceňovacích standardů a etiky v oblasti oceňování nemovitostí. Tato diskuse se objevuje i v rámci EU vzhledem k tomu, jak se důležitost vytvoření společné a jednotné platformy oceňování stává více zřetelnou. Nemovitosti tvoří podstatnou část národního bohatství a je potřebné znát jejich tržní hodnotu, aby bylo tržní prostředí více transparentní pro potenciální i zahraniční investory. Z těchto důvodů bakalářská práce dále zkoumá existenci, rozsah a vliv mezinárodních oceňovacích standardů mezi znalci.

Klíčová slova: znalec/odhadce, oceňovací proces, cena administrativní, cena obvyklá (tržní hodnota), substanční metoda, komparativní metoda, výnosová metoda, mezinárodní oceňovací standardy

Content

1. Introduction

Valuation of property has always played an important role in the society. Even though specific purposes of a valuation may differ the basis is always to provide a supportable opinion of value of the real property to be appraised. The valuers' profession in the Czech Republic has a long established tradition with the first Decree on valuation dating back to the year 1897. At present state, the Czech legal system recognizes two different types of professional valuers: (1) *Sworn-in valuers* are appointed under the Act No. 36/1967 Coll. These court experts mainly deal with setting the state-regulated administrative price of real property for tax and fees purposes required by the Czech financial authorities. While doing so, they have to obey the Law No. 151/1997 Coll., on property valuation, and the amended Acts issued by the Czech Ministry of Finance. Additionally, they are allowed to determine the real market value of the property as well. (2) *Valuers and foreign experts* performing on the basis of a "Trading licence" issued by the Ministry of Industry and Trade are generally guided by their own codes of practice and professional standards and are allowed to determine the real market value only. They are usually evaluating real property for other than administrative purposes – typically for banks or insurance companies using own independent methods defined by these institutions.

Without doubt, the two different price levels are of central importance – despite the historical reasons, this situation seems to be inconsistent with present real estate market development. Even though the Acts of the Ministry of Finance attempt to use widely internationally recognized methods for determination of the administrative price, the coefficients and techniques defined in the Acts leave no space for consideration and adjustment of the specific and unique real property to be appraised. In many cases, this leads to large differences among the determined administrative price and real market value of the same real estate property. This could be solved by adoption of the international valuation standards which provide only general recommendations and procedures and thus leave more space for individual adjustments based on the knowledge and experience of the valuer with the local real property market.

2. Thesis Objective and Methodology

The thesis objective is to supply an overview of the present legal regulations on valuation of property in the Czech Republic, to draw attention to the duality of price levels of real estate currently used (administrative price vs. market value) and the duality in conditions for exercising the valuers' profession (either as an expert sworn-in valuer or as a valuer holding a trade licence). The valution process as such will be analyzed and the valuation methods will be examined with view to their applicability. Furthermore, the methods of valuation used in the Czech Republic will be compared to the methods recommended by international valuation standards whose impact will be evaluated.

Analysis of relevant documentation, legal regulations and publications will be discussed and backed by interviews with valuers. Moreover, a critical examination of the procedures set in the valid valuation Act No. 456/2008 Coll. of the Ministry of Finance will be carried out in order to asses differences between the Czech legislative regulations and recommendations published in the international valuation standards. Using a questionnaire the opinion of the Czech sworn-in valuers will be surveyed and results will be discussed.

The result should be a compact document exploring the valuation profession, process, and trends in the Czech Republic with special consideration of the impact of international valuation standards.

3. Literature Overview

3.1 Definition of Key Terms

Administrative price

Administrative price is the term for indication of price determined according to specific legal act, under which the Law No. 151/1997 Coll. on property valuation is understood together with the Act No. 456/2008 Coll., on prices of buildings and land. The valuation of real estate has to be elaborated with accordance to this law in cases defined by the corresponding state body within its competence, in cases where other legal regulation states so or if the involved parties agree so.

There exist many equivalent terms for the administrative price in the Czech language ("cena zjištěná / administrativní / úřední").

Highest and Best Use

- "The reasonably probable and legal use of vacant land or an improved property, which is physically possible, appropriately supported, financially feasible, and that results in the highest value. The four criteria the highest and best use must meet are legal permissibility, physical possibility, financial feasibility, and maximum profitability. " [24]

To determine the highest and best use the subject site is typically evaluated under two scenarios: as vacant land and as presently improved. In both cases, the property's highest and best use must meet the four criteria described above.

International Valuation Standards – please see Chapter No. 4.1

Market Value

Valuation is most often formulation of an opinion of market value expressed in monetary units. This market value is defined by the International Valuation Standards Committee (**IVSC**) as "The estimated amount for which and asset should exchange on the date of valuation between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgably, prudently and without compulsion." [47] [48] This definition has been adopted by both the European Group of Valuer's Associations (**TEGoVA**) and the Royal Institution of

Chartered Surveyors (**RICS**) and is almost identical with the definition indicated in the Law on Property Valuation (§ 2 of Law No.151/1997 Coll.) issued by the Czech Ministry of Finance: "Market value is the value which would be reached when selling the same or comparable real estate in usual business relations in the domestic country on the day of valuation according to its condition and quality when all circumstances are taken into consideration having influence on the price, but influences of extraordinary circumstances of the market, personal relations of the seller or the purchaser, or the influence of special favour are not reflected in the price." [45] The Czech terminology does not have unified term for the market value (instead it uses many equivalent terms, i.e. "cena obvyklá / obecná /sjednaná / tržní"). [20]

Real Estate (often used synonymously with the term "real property")
- "Physical land and the structures and/or improvements attached to it." [12]
- "An identified parcel or tract of land, including improvements, if any." [24]

Real Property (often used synonymously with the term "real estate")
- "The interests, benefits, and rights inherent in the ownership of real estate." [24]

Subject Property
- Property to be appraised; the subject of the valuation.

Valuation (synonymous with the term "appraisal")
- "The act or process of estimating the market value, or other properly defined value of an identified interest or interests in a specific parcel or parcels of real estate as of a given date." [24]

Valuation process
- "A systematic procedure employed to provide the answer to a client's question about real property value." [24]

Valuation report (synonymous with the term "appraisal report")
- "A written or oral communication of an appraisal; the document that is transmitted to the client upon completion of an appraisal assignment." [24]

Valuer (synonymous with the term "appraiser" and/or "surveyor")
- "One who is qualified to estimate the value of real estate." [30]

3.2 The Valuers' Profession and Legal Regulations

3.2.1 The Profession of an Asset Valuer

The property appraisal in the Czech Republic can be in principle exercised as a profession under two regimes: either on basis of an issued Trade Certificate ("odhadce") or as a judicial-sworn-in expert activity in the field economy - price determination according to the Law No. 36/1967 Coll. on experts and interpreters ("znalec"). The common official term for this profession in the United Kingdom is "VALUER", "ASSET VALUER", "SURVEYOR" eventually "VALUATION SURVEYOR". In the U.S.A., Russia and most of Asia the term "APPRAISER" and/or "VALUATOR" is used. In France, for example, the expression "EXPERT" is prevailing.[1] [20]

The profession of valuers is not directly legally defined under the present conditions. It can be indirectly derived from the Law No. 36/1967 Coll. on experts and interpreters, as amended, and from the implementing Act, issued by the Ministry of Justice, No. 37/1967 Coll., on experts in the field economy - sector prices and appraisals, as amended. The definitions used in these laws are, however, very general and relevant for experts from different fields of practice. [20]

The most relevant and widely accepted requirements for pursuing a career as a valuer state that the valuer should be "a person of good repute, who can demonstrate that:

- he/she has obtained an appropriate degree or postgraduate qualification, has professional postgraduate experience and can show that he/she has maintained and enhanced his/her professional knowledge through a relevant programme of continuing education; and
- he/she has sufficient knowledge and experience in valuing fixed assets in the location and category of the asset; and
- he/she meets all legal, regulatory, ethical and contractual requirements related to the assignment; and

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[1] The terms "valuer", "appraiser", and "surveyor" are used interchangeably in this document to identify a person whose profession is the valuation of real estate.

- he/she has appropriate professional indemnity insurance cover in relation to the responsibilities incurred on each assignment." [5]

In general, it is important that the valuer can support evidence of his/her professional experience; educational background and training; business, professional, and academic affiliations and activities. [23] The valuer should be also committed to professional conduct, protection of the clients' confidential information and maintenance of general moral and ethical principles.

3.2.2 Current Legislative Situation

The valuers in the Czech Republic have to face the issue of two price levels – namely the regulated and unregulated prices. In majority of the cases, the prices are *unregulated* (also called negotiated or open price, eventually market value) and defined accordingly to the Act on prices No. 526/1990 Coll., as amended. The *regulated* (also called administrative) prices are governed by valid laws and acts issued by the Ministry of Finance of the Czech Republic or by other relevant departmental ministry. Among the laws used for the determination of regulated prices belong the Law No. 151/1997 Coll., on property valuation; and the amended Act No. 456/2008 Coll., on prices of buildings and land.

[3] [6]

The current legislation basically allows two types of valuers' activities:

1) The first pattern allows a valuer to appraise property on basis of his/her Trade Licence. This area is regulated by the Act No. 455/1991 Coll. ("Trade Act"), particularly by its Appendix No. 2. Since June 1, 2008 when the amendatory Act No. 130/2008 Coll. came into force, the sector "Valuation of real estate" of the Trade Act is managed as a regulated trade (previously licence trade). However, the licence does not permit the valuer to serve as a court expert or to determine the administrative price of real property. The general conditions for the operation of a trade are permanent residency in the Czech Republic; the ability to speak fluently Czech or Slovak; age of at least 18 years; the capability to perform legal tasks, and a clean criminal record. Requirements on education of the valuers are specified in the Appendix No. 2 of the Trade Act. [20] [46]

2) The sworn-in court valuer, sometimes called expert witness, is liable to the Act No. 36/1967 Coll.[2], on experts and interpreters, in the sense of latter regulations; and to the implementing regulation of the Ministry of Justice No. 37/1967 Coll. This expert activity, in terms of law, is understood as an activity done for state and governmental bodies as well as an activity carried out in connection with legal acts of both individuals and organizations. The sworn-in valuer in the field "Economy - sector prices and appraisals" is appointed by the Minister of Justice or by the presiding judge of the regional court with jurisdiction according to the applicant's place of residence. The regional court requires fulfillment of conditions specified in the §4 of the Act No. 36/1967 Coll. – these are: the Czech citizenship; the requisite knowledge and experience from the field; personal qualities for the dutiful performance of expert activities as a court expert; and agreement with the appointment (in justified cases may the Minister of Justice remit the requirement for the Czech citizenship). The appointment of valuation experts takes usually place twice a year. Upon its appointment, the valuer makes an oath, is recorded in the list of experts and interpreters for the regional court in question, and receives a confirmation authorizing him/her to use an expert seal bearing the Czech symbol – the Lion. He/she is then included to the list of experts and interpreters administrated by the Czech Ministry of Justice (this list is also available online on the official webpage of the Ministry of Justice). [6] [20] [36]

What the authors Alastair et al. (2006) already pointed out in their publication for Belgium can be applied to the Czech Republic as well: "It should be stressed that the practice of valuation is not exclusive to surveyors-valuers but involves other individuals and professionals (there are other persons employed in the brokerage activities without specific valuation education). Furthermore, the title of a valuer is not yet legally protected. For example, civil servants in registration offices control notarial acts, control the market value and basis for taxation; estate agents give free estimations to client vendors; mortgage companies generally employ their own internal valuer and architects are involved in the costing of buildings." [1]

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[2] The § 21-23 of the Law No. 36/1967 Coll. also govern the functioning of valaution institutes.

3.2.3 Historical Development of Property Assessment and its Administration

Appraising has always been a part of our lives and one of the primary and elementary human activities. In the past, determination of property value played a crucial role in the exchange business – the exchangeable value of the good needed to be estimated within the everyday exchange of goods. In that times, it were mainly market traders, i.e. people who came to the market to sell or exchange their product, who were actively performing estimations about the value of their goods. In this initial development phase of human society the price was set empirically, by comparing the time, effort, and labor exercised to acquire the individual good. In other words, the price was set by the market, which was inevitably linked with this exchange. The good was exchanged for the price at the market place, in today terminology for the "market value". [20]

In the next stage of human society development the established forms of society (empire, kingdom, republic etc.) needed to be strengthened and ensured by taxes collected from its inhabitants. Upon the taxes collection the "ad valorem tax system" was used, i.e. the amount to be paid depended on the value of property owned. This value had to be expressed in the form of monetary units. Consequently, a function of an assessor was needed, who would asses the value, and whose chief task would be to identify and appraise all property in his jurisdiction. These assessors, who were responsible for administering the ad valorem tax system were the first valuers - assessors of value. [19]

In the beginning of the tax assessment system the value of the good which was empirically set by the market (i.e. its market value) was taken as a base for determining the height of the tax burden. The first references are preserved in the Czech octroi system[3] which was kept and recorded by the Estates of the pre-White-mountain period. This system which enabled the feudalistic representatives to carry out tax administration within their territory was highly non-transparent due to the fact that the tax was levied solely on a basis of personal declaration of owned assets. The only control possible was

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[3] Here octroi in the meaning of a tax (in Czech = berň)

comparison of past declarations with the new ones and the Estates were therefore commonly destroying the written documents. The oldest available sources are estimates of the Czech Estates' assets and catalog of Czech taxpayers from 1596.

Another reliable and systematic registers are "Registra hlavní na příjem a vydání zbírek zemských, též berně domovní"[4] dating back to 1615. On the basis of these registers continued the "Berní rula" (list of tax-payers) in 1653. However, the system used in it was not structured topographically but according to dominions, owners, and/or governors and did cover only the land of liege – not the land of feudal masters. This system has not been changed until the introduction of the Terezian cadastre in 1748 (named after the empress Maria Teresia) which was further overworked by her son the emperor Josef II. [2] First records about the listing of permanent experts appearing in front of courts are from 1787. [3]

With gradual introduction of money as mean of payment, the exchangeable value was no longer expressed in perquisites but instead converted into monetary units. The first references of money can be dated back to 2500 B.C. to Egypt (first metallic money in the form of rings) and to Babylonia (clay plates). The first known paper money appeared in 1024 A.D. in China and the first European bank notes were issued in 1661 by the Stockholm Banco (Sweden). [39] Still, the direct proportion of value and price was kept, as the value came from the necessary labor exercised to acquirement or production of the good. The value system of the society was mainly based on securing of the life itself and satisfaction of basic human needs. [20]

Industrial revolution, enhancing of productivity and loosening of man from the nature resulted in trade development and subsequently in change of the value system. Industrial large-scale production and technological progress suppressed the basic utility value of goods and replaced it with value system of the modern consumer society. In this process, significant shift from original utility value of goods and services and their price occurred. [20]

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[4] "Main Registers of Receipts and Expenditures of Municipal Collections, also Residential Taxes"

Fierce development of science and technology in the second half of the 19th and in the 20th century initiated a necessary presence of experts by the courts and simultaneously evoked the requirement for detaching the experts' opinion and report as independent judicial evidence. This was legitimized for example in the "Code of Criminal Procedure" from 1873 (valid within the Czech territory until 1950). [3]

During the period 1918-1949 several concurrently administrated lists of experts coexisted, for example:

- experts for property appraisals in execution processes,
- experts for appraisals of moveable assets given to public auctions,
- experts for bankruptcy proceedings,
- experts for tax of enrichment,
- experts for expropriation for purpose of construction and operation of rails,
- experts for investigation of ship and raft accidents on rivers Vltava and Labe,
- persons qualified to hand in surveyor's report on investigations of railway accidents.

One of the requirements for the registration into these lists of permanent judicial experts was, for example, that the applicant is at least 30 years old, possesses full civil rights, is reliable, possesses required expertise knowledge, and has an active scientific or practical connection to the branch. The last requirement was to be demonstrated by short description of education and employment from which competence for the valuers function can be concluded. Authorization was usually conducted by special interest group (such as engineering chamber, chamber of commerce etc.). The decisions for nomination as well as cancelations from the list of experts was made by Regional Courts. Every five years examinations were carried on to prove whether the experts still fulfill the specified requirements for performing as experts. [3]

The Second World War caused many changes and influenced the branch of property appraisal as well. The ordinance No. 175/1939 of the Prime Minister ordered that it is not possible to increase the price of goods and services above the price as it was on 20th June 1939 - the so-called "stop-price" was established in the Czech territory, after it had been adopted in Germany which was facing extremely high inflation. This stop-price principle caused difficulties in the branch of property appraisal, as the prices as of 20th

June 1939 could in majority of cases not been taken out from evidence of property and therefore had to be derived and deduced first of all. The price which would most probably been agreed on as of 20th June 1939 or before was then taken as a valid value of the property after the Act No. 175/1939 came into force. [20]

The Czech valuers who were members of the Communist party or members of the Jewish congregation were during the German occupation suspended from performance of their profession. After the end of the occupation the Act No. 167/1949 Coll. on sworn-in valuers and translators, regulated the valuers profession and finally unified the former lists of valuers and their nomination. The valuers were to be appointed by Regional Courts according to their permanent address of residence. To ensure control over the vaulers' activities were they imposed with a new duty to administrate a so-called valuer's journal or diary. Should the valuer proceed in contrast with the valid regulations could he been prosecuted with a warning, written reprehension, penalty of up to 50,000 Kčs (old currency), or suspended from his function. The Regional Court controlled every 5 years whether the valuers still fulfill all requirements set for performance of their profession. [3]

The continuity in property appraisal branch was significantly disrupted by the centrally planned economy in recent Czech history where price had relation neither to the market nor to the momentary situation of demand and supply. Thereupon the profession of valuers who are engaged in the real market property valuation did not exist as such - determination of regulated prices according to governmental acts and laws is not the type of creative and productive task which a valuer actively performing under the conditions of open market has to master. However, after the Czech Republic returned to the stage as a democratic country, the Czech valuers were, thanks to the long tradition, able to reassume their profession and activities on the real market property valuation. [6]

The following table summarizes the relevant acts and laws on property valuation and prices of buildings and land which were valid on the territory of the Czech state.

Table No.1: Price orders for the determination of regulated prices of real estate in particular periods

PERIOD OF EFFECTIVENESS		PRICE ORDER	
From	**Until**	**No.**	**Effect**
01.08.1897	15.08.1933	175/1897	1st Valuation Decree
16.08.1933	19.06.1939	100/1933	2nd Valuation Decree
20.06.1939	30.04.1964	Act No. 208/1950 Coll.	Act on expropriation calculation
		Act No. 228/1951 Coll.	Act on expropriation calculation
		Act No. 18/1963 Coll.	Act on prices of buildings and land, and expropriation compensations
01.05.1964	31.05.1969	Act No. 73/1964 Coll.	Act on prices of buildings and land, and expropriation compensations
01.06.1969	31.12.1984	Act No. 43/1969 Coll.	Act on prices of buildings and land, and expropriation compensations
01.01.1985	31.12.1988	Act No. 128/1984 Coll.	Act on prices of buildings and land, and expropriation compensations
01.01.1989	31.10.1991	Act No.182/1988 Coll.	Act on prices of buildings and land
01.09.1990	31.12.1990	Act No. 316/1990 Coll.	Amends Act No. 182/1988 Coll.
01.01.1991	**Continuously**	Law No. 526/1990 Coll.	Law on prices
01.01.1991	31.10.1991	Act No. 589/1990 Coll.	Amends Act No. 182/1988 Coll.
21.01.1991	31.10.1991	Act No. 40/1991 Coll.	Amends Act No. 182/1988 Coll.
01.11.1991	31.10.1994	Act No. 393/1991 Coll.	Act on prices of buildings and land
24.03.1992	31.10.1994	Act No. 110/1992 Coll.	Amends Act No. 393/1991 Coll.
01.01.1993	31.10.1994	Act No. 611/1992 Coll.	Amends Act No. 393/1991 Coll.
01.11.1994	31.12.1997	Act No. 178/1994 Coll.	Act on prices of buildings and land*
01.01.1996	31.12.1997	Act No. 295/1995 Coll.	Amends Act No. 178/1994 Coll.
01.01.1998	**Continuously**	Law No. 151/1997 Coll.	Law on property valuation
01.01.1998	30.06.2000	Act No. 279/1997 Coll.	Acton prices of buildings and land
01.07.1999	30.06.2000	Act No. 127/1999 Coll.	Amends Act No. 279/1997 Coll.
01.07.2000	31.09.2001	Act No. 173/2000 Coll.	Act on prices of buildings and land
01.10.2001	18.07.2002	Act No. 338/2001 Coll.	Act on prices of buildings and land
19.07.2002	31.12.2002	Act No. 325/2002 Coll.	Act on prices of buildings and land
01.01.2003	31.12.2003	Act No. 540/2001 Coll.	Act on prices of buildings and land
01.01.2004	31.12.2004	Act No. 452/2003 Coll.	Act on prices of buildings and land
01.01.2005	31.12.2006	Act No. 640/2004 Coll.	Act on prices of buildings and land
01.01.2007	12.01.2007	Act No. 617/2006 Coll.	Act on prices of buildings and land
13.01.2007	31.01.2008	Act No. 76/2007 Coll.	Act on prices of buildings and land
01.02.2008	31.12.2008	Act No. 3/2008 Coll.	Act on prices of buildings and land
01.01.2009	**Still valid**	Act No. 456/2008 Coll.	Act on prices of buildings and land

*This and the subsequent Acts do not address the issue of rent (originally compensations) for usage (lease) of land.

Source: [20] and extract from software program NEMO3000, version 2.95.1 (computer software for real estate valuation distributed by PLUTO-OLT s.r.o.)

3.3 Valuation Practice

3.3.1 The Concept of Price, Cost, and Value

Valuers clearly and carefully distinguish among the terms price, cost, and value. The generally accepted definition and description of these terms were defined in the core publications of the Appraisal Institute:

- "The term *price* usually refers to a sale or transaction price and applies to an exchange; a price is an accomplished fact. *A price represents the amount a particular purchaser agrees to pay and a particular seller agrees to accept under the circumstances surrounding their transaction.*" [23]

- The term *cost* "applies to production as distinct from exchange (price)." [24] "Cost may be either an accomplished fact or a current estimate." [23] "The cost of a particular commodity is a historical figure, a price paid in the past, or the cost to construct a building today. A property's cost may have little or no effect on its value today." [30]

- "*Value* can have many meanings in real estate appraisal; the applicable definition depends on the context and usage. In the marketplace, value is commonly perceived as the *anticipation of benefits to be obtained in the future*. Because value exists at a given moment, an appraiser reflects value at a particular point in time. Value as of a given time represents the *monetary worth of property, goods, or services* to buyers and sellers. *Market value is the focus of most real property appraisal assignments and its estimation is the purpose of most appraisals.*" [23]

3.3.2 The Purpose of a Valuation

"The purpose of an appraisal is the stated reason for an appraisal assignment, i.e., to estimate a defined value of any real property interest, or to conduct an evaluation study pertaining to real property decisions." [24] The client may specify the purpose of the valuation when requesting it; if not the valuer has to discuss it with the client to obtain the information and to ensure a clear understanding of the assignment. A clear understanding of the purpose for which a particular valuation is to be undertaken is essential to the identification of an appropriate basis of valuation. "Each real property is

unique and many different types of value can be estimated for a single property. The most common appraisal assignment is performed to estimate market value." [23]

A valuation may be sought in a number of situations. The most common are (together with some specific examples):

- "Transfer of ownership
  - To help prospective buyers set offering prices
  - To help prospective sellers determine acceptable selling prices
  - To establish basis for real property exchanges
  - To establish a basis for reorganizing or merging the ownership of multiple properties
- Financing and credit (loan purposes)
  - To estimate the value of the security offered for a proposed mortgage loan
  - To establish a basis for a decision to insure or underwrite a loan on real property
  - To determine the terms of lease
  - To assess the value of real property assets in financial statements
- Tax matters
  - To estimate assessed value of property taxes (e.g. transfer tax)
- Investment counseling and decision making" [23]
- Other Purposes
  - Distribution of an estate
  - Division of property as part of a divorce
  - Determination of insured value

The purpose of a real estate valuation determines the foundation for the final value conclusion and the structure of the report may be adapted to the intended use of the valuation results. [23]

3.3.3 Valuation Methods

Before further explanation of the possible valuation methods which can be applied in the valuation process, it is necessary to address the issue of two price levels and two possible types of a valuation currently coexisting in the Czech Republic. A valuation

can be done either as (1) a determination of an administrative and state-regulated price of the property or as (2) an estimation of the market value of the property. The first type ("Znalecký posudek") is done mainly for the reasons of tax base calculation - to establish the price from which the real estate transfer tax (3%) should be levied. Market valuations ("Tržní ocenění") are done for specification of market value of real estate that can be achieved on the market and is dependent on supply and demand on the market in the given time and place.

3.3.3.1 Administrative Price of Property

Valuation methods for determination of the administrative price of property

For the determination of the administrative state-regulated price of a property, the valuer has to work in accordance with the Act No. 456/2008 Coll., on prices of buildings and land issued by the Ministry of Finance. In the process of value estimation of administrative price, the valuer has to follow the methods and specific coefficients defined in this Act.

3.3.3.2 Market Value of Property

The Triad (the "Three Approaches")

The three most commonly used and generally accepted approaches which are described below are based on comparison. All three approaches are applicable to many assignments, but one or more of them will always have greater weight depending on the specific nature of each assignment. For instance, the Cost Approach is unsuitable for valuation of properties with older improvements that show significant "accrued depreciation due to physical deterioration, functional and external obsolescence, which are difficult to estimate." [23] The Sales Comparison Approach cannot be applied to value estimate of very specialized real estate as the comparable data needed for execution of this method may not be available. The Income Capitalization Approach may be unreliable especially "in the market for commercial or industrial property where owner-occupants outbid investors." [23] In the valuation process the valuer should apply at least two approaches, because the value indications obtained may serve as check for each other. [23]

The description of the approaches below is done accordingly to international valuation standards and recommendations (RICS, TEGoVA, IVSC). The Czech legislation also specifies methods similar to these but leaves less space for individual adjustments (see Chapter 4.4).

Cost Approach

This method of valuation is based on the principle of replacement - the prospective purchaser will not pay more for assets in question than the costs for their replacement. According to this approach, a property is worth its reproduction cost minus accrued depreciation plus land value. This method is most suitable for valuation of new or nearly new improvements and properties that are not frequently exchanged in the market. However, the usage of this method is restricted to some extent, because this approach does not reflect the current sales price of the specific property on the market. [23] [30]

In this relation, the terms *substance, and material value* are used. Material value means how much money it is necessary to invest to acquire the same property. In the event of purchase, substance value has clear economical meaning - it helps to solve the question whether it is more advantageous to buy an existing real estate or whether it is better to build a new one. [6]

The mathematical expression of this approach can be expressed in the following form:

$$\mathbf{V} = \sum_{i=1}^{n} \mathbf{RC_i} \times (\mathbf{1 - D_i}) + \sum_{l=1}^{m} \mathbf{P_l} \qquad \text{(Formula No. 1.1)}$$

where $\mathbf{RC_i}$...........reproduction cost of building

$\mathbf{D_i}$.............depreciation of building (in %)

$\mathbf{P_l}$..............land price [6]

The data about the current reproduction costs can be obtained from builders and contractors; the amount of depreciation can be measured through market research or can be directly determined by the expert opinion of the valuer (who is supposed to possess basic technical knowledge about building constructions) during a physical inspection of the building; the land value estimate is done separately. [23]

Sales Comparison Approach

This is the most often used method in well-functioning market economies. Out of the three approaches discussed, this method relies the most heavily on the principles of substitution, supply and demand, and externalities. Its usage is conditioned by a functioning market which should be "perfect" in the sense of sufficient frequency of sales. The sales comparison approach (also called market data approach) states that the worth of a property is equal to the price an informed purchaser would pay for it. [6] An analysis of comparable sales is required assuming that the market value of a property has a close relationship to prices of similar properties recently exchanged on the market. However, as it is almost impossible to find two exactly same properties, the valuer has to search for properties that resemble the subject property as closely as possible and then make appropriate adjustments to reflect the differences (like physical features, age and quality of the construction; location; time elapsed since the sale etc.). [30]

When applying this approach in the Czech domestic conditions a limiting factor occurs: applicable, reliable, and statistically sorted data or information databases are not available. Information about suitable comparable properties can be collected from searching public records, newspapers, magazines, advertisements or other sources[5]. However, a selective and critical consideration is necessary when using the data from these sources. [1]

The mathematical expression of this method can be defined as:

$$V = \frac{\sum_{i=1}^{n} SP_i \times \prod_{r=1}^{m} c_r}{N} \qquad \text{(Formula No. 1.2)}$$

where SP_i…………sales price of i-th property

c_r……………represents r-chosen number of coefficients of comparison for i-th property

n……………..number of studied cases [6]

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[5] For example estate agents' records of recent real property sales, diverse websites (e.g. www.reality.cz), reports about market developments (published for instance by the company King Sturge or Jones Lang LaSalle) or statistical regional data and indexes from agencies (e.g. Reuters, Bloomberg etc.).

Income Capitalization Approach

This method is formed on the assumption that the worth of property is equal to the present value of the anticipated flow of future benefits. [30] It considers the time value of money – the basic key of valuation according to this approach is in understanding the relation between flow of income and value. When buying the subject property the purchaser/investor purchases future flows of income, i.e. future income – cash flow.

Three steps are involved in the income capitalization approach to value:

- Projection of the volume, reliability and length of future flows of income;
- Specification of the correct and applicable capitalization rate;
- Usage of capitalization, i.e. "placing a currency amount on the future flows of income by applying an appropriate capitalization rate" [30]

This method implies that "the market value (V) of property equals its stabilized net operating income (NOI) divided by an appropriate market capitalization rate (R)." [30]

The mathematical expression of this method can be defined as:

$$V = NOI / R \qquad \text{(Formula No. 1.3)}$$

It can be stated even more precisely in the form:

$$V = \sum_{t=1}^{n} \frac{NOI}{(1+r)^t} + \frac{Proceeds\ from\ sales}{(1+r)^t} \qquad \text{(Formula No. 1.4)}$$

where **NOI**…………net operating income

$\quad$ **r**……………..required return (which is similar, but not identical, to R)

$\quad$ **t**……………..time in years [30]

This formula of income capitalization approach further develops the basic assumption that the market value of real estate is the present value of future benefits by stating that "for an income-producing property, the stream of future benefits is the annual cash flow over a projected holding period plus the residual cash flow from sale of the property at the end of that holding period." [30]

3.3.3.3 Application of Particular Methods

Each market value estimate is generally subject to certain error rate regardless the point of view (expert's position, mathematical model used, changes in demand and offer on the market). For this reason, several methods (or their mix) are usually used to determine the market value, although each of these methods is based on different assumptions. [6]

Expert practice has verified following equation used to compare individual market values:

$$V = (H_c \times w_c + H_s \times w_s + H_i \times w_i) : (w_c + w_s + w_i) \qquad \text{(Formula No. 1.5)}$$

where V is the resulting market value, H_c is the value identified by the cost approach, H_s is the value identified by the sales comparison method, H_i is the value identified by the income capitalization method and w_c, w_s, w_i are weights of individual methods. [6]

3.3.4 The Valuation Process

There is no universally legally determined set of steps to be applied in the valuation process because each assignment depends on the specific needs of the client and type of property to be appraised. However, a generally applicable valuation process can still be identified. A valuation process can be compared to the analytical process that any experienced investor would go through when dealing with a real estate property. [30] This process can be outlined in seven steps as illustrated in Chart No.1 below.

Chart No. 1: The valuation process

DEFINITION OF THE PROBLEM					
Identifica-tion of real estate	Identifica-tion of property rights to be valued	Date of value estimate	Use of appraisal	Definition of value	Other limiting conditions

↓

PRELIMINARY ANALYSIS		
GENERAL (Religion, city and neighborhood)	SPECIFIC (Subject and comparables)	COMPETITIVE SUPPLY AND DEMAND (The subject market)
↓	↓	↓
Social Economic Governmental Environmental	▪ Site and improvements ▪ Cost and depreciation ▪ Income/expense and capitalization rate ▪ History of ownership and use of property	▪ Inventory of competitive properties ▪ Sales and listings ▪ Vacancies and offerings ▪ Absorption rates ▪ Demand studies

↓

HIGHEST AND BEST USE ANALYSIS
▪ Land as though vacant ▪ Property as improved

↓

LAND VALUE ESTIMATES

↓

APPLICATION OF THE THREE APPROCAHES		
Cost	Sales comparison	Income capitalization

↓

RECONCILIATION OF VALUE INDICATIONS AND FINAL VALUE ESTIMATE

↓

REPORT OF DEFINED VALUE

Source: [23]

3.3.4.1 Steps in the Valuation Process

The Chart No. 1 outlines the steps which a valuer would follow to accomplish a valuation. The basic procedure is the same, regardless of the type of property to be

appraised or the purpose for which the valuation is sought. These 7 steps are in depth discussed below:

1. Definition of the Problem

The whole process starts with the definition of the problem. The valuer begins the valuation process by identifying the subject property together with the particular legal rights connected to it. Since an appraisal describes and values real estate as of a precise moment in time, the date of valuation is important and must be set. However, in some cases a valuation as of a date in the past or future may be required. A clear understanding must exist both as to the purpose or objective of the appraisal and the type of value sought any limiting conditions must be clearly stated. Most often, the appraisal is conducted to determine the market value for a prospective sale or loan. [30]

2. Preliminary Analysis, Data Selection, and Collection

After the problem has been defined, the valuer is prepared to perform a preliminary analysis. In this stage, collection of primary and secondary data as well as gathering, recording and verifying of the data relevant to the subject property is required. The valuer defines the data that will be needed and the sources of data. The necessary information may be subdivided into three types: (1) information relating to the environment in which the property is located (general market data), (2) information relating to the property itself (specific site data), and (3) information relating to the competitive position of the property (competitive supply and demand data). [30]

- *(1)General market data* - In this first category the valuer investigates general social, geographic, economic, and political features of the region and neighborhood; anticipates a possible development of these factors, and identifies expected continuance of trends in the future. He/she analyzes accessible and relevant rental data on the regional economy and considers the input of buyers, sellers, brokers, property developers and public officials. [30]

- *(2) Specific site data*: In the second category a physical inspection of the subject property is made. The site is physically inspected and examined to determine the extent of deprecation and the ability of the improvements to perform their

intended use. Furthermore, complete financial and operating information about the property are thoroughly analyzed, and numerous comparables in the subject's market are investigated. Comparables are used in all three approaches used for valuation - if some of the indicators of comparables properties differ from the subject property to be valued adjustments have to be made to make them comparable. Comparable property information includes:

- Sales price and financial terms of the transaction
- Property rights conveyed in the transaction (as these typically have an impact on the sale price of a property) and conditions of sale
- Date of sale
- Location
- Size
- Physical features and exterior and interior improvements
  - Age of the property; quality of construction; overall condition; number of rooms; layout of the rooms; functional utility; square meters of living space; the exterior and interior conditions; garage; special features such as central air-conditioning, fireplace, swimming pool, energy saving items and the like.
- Public utilities
  - The availability of public utilities has a significant impact on the value of a property. Municipal utility providers often - but not always - provide utilities such as gas, water, electric, sewer, and telephone. If the subject property does not have access to all public utilities at the time of sale downward adjustments have to be made.
- Utility (shape, access, visibility, view, design, appeal)
- Other (soil quality, slope conditions, restrictive zoning, easements, wetlands or external influences)

[26]

- *(3) Competitive supply and demand data*: These data show the competitive position of the subject property in its future market. "Supply data include inventories of existing and proposed competitive properties. Demand data

include population, income, employment, and survey data referring to potential property users." [23]

At this point, all the data the appraiser will need to arrive at final value opinion of the subject property have been gathered. The type and structure of the data sought depend on the assignment and the type of property to be valued. Each step in the valuation process should be carefully planned and scheduled – this will allow a reasonable data assembly and allocation of appropriate amount of time to each step of the process. [23]

3. Highest and Best Use Analysis

In 1826, one of the first regional economists – Johann von Thünen (1783-1850) published a book called "The Isolated State" (in original "Der Isolierte Staat"). In his book he described agricultural locations in Germany and became the first one who seriously attempted to incorporate the spatial element in pragmatic economic thought by comparing how agricultural land use differs with growing distances from market centers. His work first gave expression to what has become the *highest and best use principle* which is today one of the most-quoted and best-known principles of real estate valuation. This concept is modeled upon the principle that "land is valued on the basis of the use that, at the time the appraisal is made, is likely to produce the greatest return" [30].

The highest and best use analysis of the land as though vacant and of the property as improved is a fundamental part of the valuation process. This analysis enables the valuer to interpret the market forces that influence the subject property and to freely consider any reasonable potential use (in case of vacant land) or to analyze alternative uses with respect to the existing use, its prospective future returns and the costs of demolition (in case of land already improved). [23]

4. Land Value Estimate

The opinion of land value is often developed independently and apart from the value of any constructions. "The land value is directly related to highest and best use and may indicate whether an existing use is the highest and best use of the land. The land value

may be a major component of total property value. Appraisers often estimate land value separately, even when valuing properties with extensive building improvements." [23] The reason requiring the land value estimate to be carried out individually in the frame of the valuation report is the fact that land value usually changes at different rate compared to buildings (which are almost always subject to depreciation). [23] [30]

Generally, the Sales Comparison Approach is used to establish the land value. By means of this method the current offerings are examined and prices recently paid for comparable sites are analyzed. The key elements of comparison of properties with similar characteristics to those of the subject to be appraised include the price per square meter of land, transferred property rights, financial terms of the transaction, location of the property, its utility, the specific physical characteristics of the real estate, and the conditions associated to the sale. If the comparable land is superior to the subject of valuation, a downward adjustment has to be made and vice versa. [26] [30]

5. Application of the Three Approaches

There exist three separate market-derived and generally accepted approaches which have been developed over the years to assist the valuer in elaborating an opinion of value: (1) Cost, (2) Sales Comparison, and (3) Income Capitalization Approach. In the valuation process, each of this method is considered and then either included or eliminated based on its applicability to the property being valued and the type and quality of information available. The reliability of each approach depends on the availability, comparability of market data and their applicability to the assignment.

Some literature recognizes more than these 3 basic methods: for example the practice in the U.S.A. distinguishes between 8 approaches used for calculation of market value. Nevertheless, the recent development of the profession shows that even in the U.S.A. the number of the applied methods came down to the basic three mentioned above. This has been proved by the recent article published in *The Appraisal Journal*: "The initial concepts and structures of the appraisal process in the United States included at least eight valuation methods. The majority of appraisers, however, basking in the perceived simplicity of three approaches to value and sustained by short education courses, have

embraced this simple triad."[35] The Czech literature is familiar with the three fundamental methods: (1) comparison method ("metoda porovnávací/komparativní"), (2) method for calculation of substantial value ("metoda stanovení věcné hodnoty – substanční"), and (3) income method ("metoda výnosová"). [6] [20]

Each of these approaches is in depth discussed in the Chapter 3.3.3.2. At this point, only the fundamental principle of each method will be pointed out:

1. *The Cost Approach* relies on the predication that an informed purchaser would pay no more for the subject than the cost to produce a substitute property with equivalent utility.

2. *The Sales Comparison Approach* states that a property is worth roughly the same as another property producing the same utility. To estimate a value of the subject property it reflects sales of comparable properties (which have to be adjusted in case of differences).

3. *The Income Capitalization Approach* operates with the assumption that value of property is connected to the income it is capable to generate (to the future cash flows that the property is expected to produce).

[23] [26] [30]

6. Reconciliation of Value Indications and Final Value Estimate

The last analytical step in the valuation process is the reconciliation of the value indicated by each of the three appraisal approaches. The opinions of value reached by these three approaches will rarely be the same. However, the valuer must not simply calculate the average of the differing obtained value opinions. Each approach used in the valuation process is analyzed and judged based on its applicability to the subject property and valuation purpose, reliability, and the quantity and quality of its data. Finally, the value indications derived by the valuation process are reconciled into a single figure or a range into which the value would most probably fall. This final estimate of value of the property as of a particular date either resembles one of the approaches, or is a correlation of all the approaches used. In this section of the report the valuer can explain the variations among the values obtained by the three approaches and

based on his/her previous analysis and knowledge, clarify why the one specific approach was considered to be more necessary and applicable than the other two. [23] [26]

7. Report of a Defined Value

An assignment is not finished until the results and conclusions are presented in a written form to the client. This is usually done in the form of an appraisal report which consists of the seven steps just explained. This report is the evidence, reasoning and defense of the final value defined by the property valuer. [23] [30]

The report of a defined value is the tangible manifestation of the valuer's work. It includes all the data which were used and analyzed in the valuation process, the methods applied, and the reasoning of the procedure which led to the final value estimate. This report should assist the reader in understanding the problem and in comprehending the process behind the valuer's conclusion of value. [23] [30]

The final defined value estimate (**V**) represents the valuer's opinion, reflects his or her experience and judgment that were applied in the valuation process and can be expressed as sum of the total value of improvements (I_v) and total value of land (L_v):

$$V = I_v + L_v$$
(Formula No. 1.6)

"It should now be apparent that property appraisal is an art, not a science. An estimate of value is never spoken of as a scientific fact, but rather as an opinion." **[30]**

It has to be emphasized that the above cited statement applies to market value estimation. The process of determining regulated administrative price according to the valid Czech legislation has been simplified into routine operations rather than a creative expert activity.

4. The Impact of International Valuation Standards on Valuation Process of Real Estate in the Czech Republic

The valuation methods applied to the value estimate of administrative price are set in the Law No. 151/1997 Coll. and the Act. No. 456/2008 Coll. Definition of market value can also be found in the Law No. 151/1997 Coll. In this chapter the impact of other internationally recognized approaches and methods concerning the branch of real estate valuation will be examined. To evaluate the impact of the international real estate valuation standards these have to be defined first (see Chapter 4.1). However, it should be stressed that none of these international valuation standards is legally binding in the Czech Republic. The valuation methodology recommended in the international valuation standards is "a matter for the professional judgment of the valuer dependent on circumstances relative to an individual instruction". [34]

4.1 International Valuation Standards and Institutions

4.1.1 European Valuation Standards TEGoVA

Among the well-known and generally accepted standards belong the European Valuation Standards which are published by TEGoVA. The current sixth edition was launched on 1st April 2009 as the "**EVS 2009 (The Blue Book)**". The publication EVS 2009 is divided into two parts: the first sets five core European Valuation Standards and the second consists of five European Valuation Applications. "The EVS 2009 considers valuation issues in a European context and, in particular, addresses the valuation requirements and definitions of the European Union and the European Commission." [48] "It has adopted definitions that are in common with International Valuation Standards (IVS) and that accord with EU Directives, specifically the definition of Market Value. The EVS does not address any country specific issues." [34]

TEGoVA (established in 1977 and based in Brussels) is pan-European organization of national valuers' associations with 39 members from 24 countries. Its aim is to provide set of standards for valuations which are "consistent across Europe, with a quality that can be relied upon as a common benchmark by clients throughout the EU. These standards provide a robust response to the European Commission that seeks harmonization of standards and valuation qualifications in all countries of the European Union." [34]

Among its members belong well-reputed organizations such the RICS (UK) and The Appraisal Institute (U.S.A.). The only member in the Czech Republic is "The Czech Chamber of Appraisers" which has around 300 members. [42]

4.1.2 The Red Book – RICS Valuation Standards

The Valuation Standards (The Red Book) published by the RICS comprises mandatory rules and best practice guidance for RICS members active in real estate valuations. RICS has published valuation guidance and standards since 1976 - the current sixth edition of the Red Book was issued in 2008. The history of RICS can be traced back to 1792 when the Surveyors Club was formed. However, it exists under its current name since 1946 when the title "Royal" was granted to the Institutions of Chartered Surveyors. Today, RICS operates in 146 countries via its extensive network of regional offices around the world. The RICS works to "establish high educational and professional standards and helps to set, maintain and regulate standards and provides advice to governments and policy-makers." [33] RICS members have background from "diverse range of land, property and construction related issues." [33] As of December 31, 2008 RICS had 80 members in the Czech Republic. However, only 6(!) of them were RICS members in the category Valuer/Appraiser – out of these 6 only 2 had the Czech nationality and none of them was registered as the expert valuer by the Ministry of Justice. [40]

4.1.3 International Valuation Standards - IVSC

The IVS are published by the International Valuation Standards Committee (IVSC). The current eight edition was published in 2007 as "**IVS 2007**" and is structured into

three parts – (1) 3 International Valuation Standards, (2) 3 International Valuation Applications, and (3) 15 Guidance Notes. In the IVS, "much attention has been given to standardizing terminology and identifying relationships to international accounting standards. The demand for valuations prepared under International Valuation Standards is being driven by the rapid adoption around the world of International Financial Reporting Standards, the growing influence of Public Sector Accounting Standards, and the increasing need for users of valuation reports to have a consistent and comparable measurement of assets wherever they may be." [37]

The IVSC is an independent, non-profit organization incorporated in the U.S.A. It is a member of the United Nations and has headquarters in London. The IVSC was founded in 1981 as a joint venture of the UK based RICS and the Appraisal Institute based in the U.S.A. and has published IVS since 1985. The primary purpose of the IVSC was the development of a set of common international real estate valuation standards for purposes of financial reporting, in relation to the development of International Accounting Standards (IAS, now known as IFRS) by the International Accounting Standards Committee. Today it follows the objective to "develop and maintain a highly effective comprehensive set of high quality international valuation standards" [32] and thus expands its scope to the harmonization of international real estate valuation practice in general. [32]

The IVSC includes national associations from 52 countries, including the RICS (the Czech Republic is not a member) and maintains liaison with international agencies (OECD, the World Bank, IMF, WTO, BIS) as well as a close relationship with standard-setting bodies such as the International Accounting Standards Board or the International Federation of Accountants. [38]

4.2. Development in the number of valuers in the Czech Republic

Before analyzing the impact of international valuation standards it would be interesting to observe the development of number of valuers active in the Czech Republic.

The number of sworn-in court valuers (experts) appointed by the Minister of Justice or by the presiding judge of regional courts shows a stable progress – since 2002 the number has not fallen under 3000 and according to my personal inquiry at the ministerial department for supervision, the number has shown similar values since and even before the "Velvet revolution" in 1989. Apparently, majority of the sworn-in valuers active in the Czech Republic has been appointed before the transition from centrally planned to free market economy in 1989.

Graph No. 1: Number of sworn-in valuers in the Czech Republic in the field economy, sector prices and appraisals, specialization real estate[6]
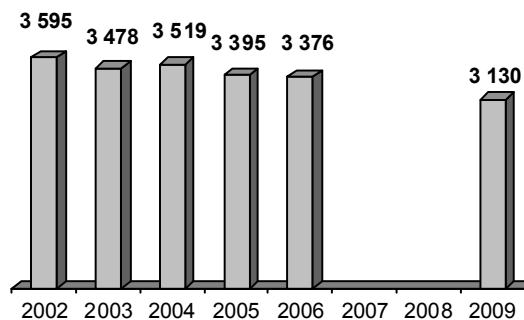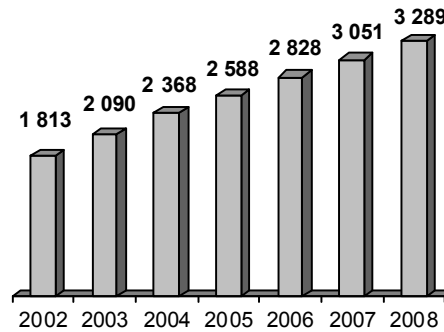

Source: *The Ministry of Justice –Department of Supervision (Sekce justiční – Odbor dohledu)*

In contrast to the development of number of sworn-in valuers, the number of valuers operating on basis of a Trading licence showed a fierce progress since 2002 as it is demonstrated in the following graph. Whilst the Graph No. 1 illustrates only the sworn-in valuers with the specialization of real property appraisals, the data for valuers working on basis of a trade certificate are available for the whole appraisal sector only (i.e. appraisal of movable property, real property, intangible property, financial property and enterprise).

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[6] The exact data for years 2007 and 2008 have not been published yet, the Ministry of Justice is currently computing the data for 2007. Every year in spring the regional courts send the data about registered sworn-in valuers to the Ministry of Justice which then starts to compile these data at the end of the next calendar year. The data for 2009 are taken form the online evidence of sworn-in valuers (experts) and translators on the website of the Ministry.

Graph No. 2: Number of valuers operating on basis of a trade licence in the Czech Republic[7]

Source: *The Ministry of Industry and Trade –Department of Methodology and Education (Oddělení metodiky a vzdělávání)*

4.3 Questionnaire Survey –Data Analysis

The design and distribution of questionnaires is an extensively used scientific method attempting to analyze obtained data in a structured and coherent way. 6 questions (2 of them open-ended) were extracted based on the notions and issues that have been discussed in the previous chapters and were assessed by Czech sworn-in court valuers (experts). Further in-depth information was gathered by semi-structured and unstructured interviews with 2 other valuers. The aim of this interviews and questionnaire was to analyze whether and to what extent the Czech valuers see a need for amendments to the current Czech legislative concerned with the valuation of property with regard to the growing demand for harmonization of education, valuation methods and procedures in the sector of valuation of property across the European Union. The TEGoVA was the first institution to realize the urgency of European convergence in property valuation and draw attention to the need of cooperation to ensure that the valuers possess the knowledge to give accurate and informed advice to clients which would be comparable across Europe. It is working together with the European Commission to establish a common education platform and to develop

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[7] Until June 30, 2008 administrated as "licence trade" – category K31438. With effect from July 1, 2008 supervised as "regulated trade" – category V21460.

detailed common standards which would be valid in all European countries. When investors and service providers in the real estate industry execute cross-border transaction they often come across valuations that are incomparable due to different methodologies used based on different valuation systems and qualification requirements for valuers established in the individual countries.

The questionnaire was distributed to sworn-in court valuers who are members of one professional association in the Czech Republic (for reasons of personal data protection and agreement with the management of the association, neither the name of this association nor the name of the individual valuers can be published here). The questionnaire was sent out via email to 512 valuers who gave permission to receive materials and advertisements to their email address. 83 responses were received which represents a response rate of 16.21%. A detailed breakdown of the received responses is contained in Supplement 7.2. Considering the nature of the professional association to which members this questionnaire was dispatched it was assured that participants of this questionnaire were only the sworn-in courts expert valuer (not the valuers active on base of a "Trading Licence"). This was vital for the results as only the sworn-in valuers are permitted to derive both types of real property prices (i.e. administrative and market) and to ensure that all of them have comparable education required by the Act No. 36/1967 Coll., on experts and interpreters, have the Czech nationality and are professionally active in the Czech Republic. The responses were given in form of answers to 4 "tick-box" and 2 open-ended questions. The aim of the survey was to analyze the view of the court experts on the current legislative situation and the influence of international standards on the valuation process in the Czech Republic – therefore, information about their age, sex, or permanent address were irrelevant.

From the executed survey, following results can be drawn which (also according to the interviews with the valuers and prior analysis of legislative situation) could be seen as typical for the current state of property valuation in the Czech Republic:

- According to 65 respondents (representing 78.31%) the current dual price level - with state regulated prices on one hand and non-regulated market prices on the other hand – corresponds to the historical development of property valuation in

the Czech Republic, is acceptable and not unusual with regard to some other European states (for example Denmark and Sweden). 12 respondents (i.e. 14.46%) agree that this dual price level contradicts the principal assumptions of free trade and should be rejected together with Acts on property valuation of the Czech Ministry of Finance which regulate the process of administrative price determination.

- 100% of respondents agree that the Act on expert and valuers No. 36/1967 Coll. and No. 37/1967 Coll. have to be amended, overworked and adapted to current situation by the Ministry of Justice (especially issues such as remuneration of work; specific and clear definition of valuation fields; definition of requirements for education and performance of the profession). This is simply justified by the date when this Act entered into force – i.e. the year 1967. In that time the economy was centrally controlled and the conditions valid in that time are not adequate and applicable 42 years later.

- Only less than 30% (26.51%) of valuers in the Czech Republic are acquainted with the international valuation standards published by TEGoVA, RICS or IVSC.

- This is imminently connected with responses stating that 48.19% of valuers find the current Act of Ministry of Finance on valuation as satisfactory with no need for further amendments and the same number of valuers feels no need to make the international valuation standards published by RICS, TEGoVA or IVSC legally binding in the Czech Republic.

- Even though quite a high number (74.7%) of valuers are certified according to the domestic ČSN ISO 9002, only 2.41% of Czech sworn-in valuers are certified by TEGoVA and none (!) of them is certified member of the RICS.

4.4 Questionnaire Survey – Discussion of Results and Recommendations

The data acquired through the completed survey indicate that only one quarter of the respondents has encountered any international valuation standards published by RICS, TEGoVA or IVSC while pursuing the work of a valuer. In the opinion of 50% of the respondents, the current valid Act of Ministry of Finance No. 456/2008 Coll. does not need to be amended or revised. To understand the forces behind this opinion it would be advisable to return to the Graph No. 1 showing the development of number of sworn-in valuers and to the Act No. 36/1967 Coll., on experts and interpreters. On basis of the data concerning number of sworn-in valuers and after the interview with the relevant employee of the Ministry of Justice, it is evident that the majority of the sworn-in valuers actively pursuing their profession today were appointed during the last political regime. Typical for the centrally planned economy were state regulated prices which – in cases of real estate – were determined in accordance with the Acts of Ministry of Finance (of the then Czech Socialistic Republic). These Acts carefully specified how to estimate the price of a real property in very detailed way. As a result, the valuer needed to manage only two prerequisites: to be able to measure the proportions of the real property and to have knowledge of the Act of the Ministry of Finance. This was actually enough to be able to determine the administrative, regulated price of the real property.

Technically speaking, this process is clearly insufficient to determine the market value in the open market economy. Indeed, the methods used to estimate the market value require more individual involvement of the valuer than to institute coefficients defined by the Act (state) into simplified mathematical formulas. The market value estimation is a formulation of an expert opinion of value which is influenced not only by the situation on the real estate market but also by experience of the individual valuer. For this reason, the international valuation standards are relatively general regarding the specific value estimation. Equally, the published standards (including the Red Book of RICS and the Blue Book of TEGovA) do not mention any specific and defined values of the coefficients whereas the Czech legislative regulations do.

A good example might be the capitalization rate demonstrating how the Act of the Ministry of Finance reduced the complex estimation process of the market value to a simple mathematical operation, particularly the *income capitalization approach.* According to Section I. of the Act. No. 456/2008 Coll, the income administrative price of a real property is determined by dividing the annual net profit from rent by the defined capitalization rate. The annual net profit is strictly given as 60% of gross profit.

Table No. 2: The capitalization rate for valuation of real property and property rights using the income approach

ITEM NO.	ITEM NAME	CAPITALIZATION RATE (%)
1	Real property for production and garages	10
2	Real property for trade and administration	7
3	Real property for mass accommodation and catering	8
4	Real property for transportation, communication, and education	9
5	Real property for culture	8
6	Real property for health care	8
7	Real property for agriculture	7
8	Real property for storage	6
9	Real property for housing (flat-buildings)	5
10	Other real property	8
11	Property rights	12

Source: *Appendix No. 16 of the Act No. 456/2008 Coll.*

This procedure for determination of real property market value by means of income approach degrades the whole approach to substitution of 2 defined coefficients into a simple formula:

$$IAP = NOI/r \qquad \text{(Formula 2.1)}$$

where **IAP**…………income administrative price of the property

NOI………...net operating income

r……………..capitalization rate.

However, the task of the valuer is to analyze and consider all possible uses of the real property, in other words to proceed according to the "Highest and Best Use" analysis. In

contrast to the technique defined by the Czech law, to quantify the real and feasible rent and thus the applicable capitalization rate, the valuer should use other methods and approaches. The capitalization rate simplified into a table as might be seen above does not reflect the economic situation and the probable development of rents of similar properties to the subject property.

In fact, the capitalization rate **R** (that is the required rate of return) expresses also the level of risk connected to the investment. This risk is quantified on basis of the nature of the business sector, competitive environment, business environment of the state (economical, legal and commercial aspects), and forecasted potential of the subject. In addition, other factors have to be taken into consideration, such as the current economical and political climate of the Czech Republic; actual interest rates; rate of return of securities with long term validity warranted by the government on the stock market (as these values illustratively represent the so-called risk free level of investment return); risk connected to inflation development; uncertainty connected to fiscal policy of the state; uncertainty connected to specific characteristics of the subject property. With special view to real property valuation, methods like CAPM (Capital Asset Pricing Model) or the Built-Up method (identifying 4 basic elements of capitalization rate) are frequently used to determine the risk premium and the capitalization rate. This clearly illustrates that the determination of the capitalization rate R is a complex and sophisticated procedure based on thorough analyses of the environment which cannot be simplified into substituting pre-defined coefficients into a straightforward formula.

Similar issue of oversimplification can be observed by applying the ***cost approach*** to determine the substantial, material value of the real property. As it is shown in the following table, the Act No. 456/2008 Coll., again, sets specific and detailed prices for m^3 of built volume of the building.

Table No.3: Basic prices for m³ of built volume of a building and its standard equipment

TYPE	NO. OF SKP	CODE CZ-CC	PURPOSE OF THE BUIDLING USAGE	KČ/m³ BUILT VOLUME
A	46.21.18.1..1	1264	Buildings for health care	2 740,-
B	46.21.14.6..1	1272	Buildings for church services	2 830,-
	46.21.19.9..1	1274	Other non-flat buildings	
C	46.21.17.1..1	1263	Schools, universities, and buildings for research	2 538,-
D	46.21.16.3..1	1261	Buildings for community and cultural purposes	2 611,-
E	46.21.63.1..1	1265	Buildings for sports	2 579,-
F	46.21.14.3..1	122	Buildings for administration	2 807,-
		123	Buildings for services	
G	46.21.19.1..1	121	Buildings of hotels	2 710,-
		113012	Buildings for accommodation of students, employees, etc.	
H	46.21.14.2..1	123	Buildings for trade (public catering)	2 669,-
I	46.21.18.2..1	113011	Other flat buildings (social care)	2 239,-
J	46.21.12.1..1	112	Multiple-flat houses (standardized)	1 950,-
K	46.21.12.2..1	112	Multiple-flat houses (non-standardized)	2 150,-

Source: *Appendix No. 2 of the Act No. 456/2008 Coll. (only selection from the original table)*

Owing to this over-generalized modus operandi defined by the Ministry of Finance, the basic price as stated in the Appendix No. 2 of the valid Act is only multiplied by the number of built volume (i.e. m³), adjusted by use of pre-defined set of coefficients[8] and finally lowered by depreciation and with that, the estimate of substantial value of the real property is completed. As a result, this process reflects neither the level of local supply and demand for construction works nor the prices of construction materials. The valuer works with averaged values and coefficients whose applicability to real price of the subject real property in a given location and time is problematic. However, from the

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[8] These coefficients express the price change of m3 built volume against the base year 1994 (1994 =1.00) and are assessed only on the base of yearly change in inflation as published by the Czech Statistical Office. For example the coefficient K_i (coefficient of change in buildings prices defined in Apendix No. 38 of the Act No. 456/2008 Coll.) in the year 2009 ranges from 1.9 to 2.3.

view of the valuer, the procedure ordered by the Act of the Ministry of Finance is easy to follow and in case of complaints easily verifiable and supportable.

Even in the *comparison approach* analogous problematic issues can be identified. For example, the §26a of the Act No. 456/2008 Coll. namely defines factors influencing the price of a real property within the scope of comparison method together with permitted levels of the influence of individual factors. According to this paragraph, the end price of a family or recreational house is derived by multiplying the m^3 of built volume by the basic price as specified in the Appendix No. 20 and adjusted in accordance and only within the range of specified coefficients. Very likely, this proposed technique of price determination does not take into account incalculability of the real property market and ignores the experience of the valuer with the market which could bring invaluable added value to the appraisal.

From the above stated practical examples, it can be concluded why the Czech valuers (namely the respondents in the completed survey) have so supportive attitude towards the current valid Act of the Ministry of Finance. The value estimation process as defined in the Act is simplified into uncomplicated steps and multiplying of pre-defined coefficients. Therefore, the demand for individual and responsible work of the valuer and his/her efforts are minimal. However, the real property market is lively and changing very quickly – the changes in market values are (among other factors) mainly functions of time. This is regrettably only partially reflected in the Act of the Ministry of Finance and explains the occurrence of frequent cases where the administrative price (determined in accordance with the Act) and market value (determined on basis of more free-space allowing methods) of the same subject real property differ at the rate of millions Czech crowns.

From this viewpoint, the international valuation standards are more acceptable and suitable as they provide only general instructions for market value determination. Concrete coefficients are to be chosen and applied to the recommended formulas by the valuer him-/herself based on his/her own beliefs, expert opinion and experience with the local market.

4.5 SWOT Analysis

STRENGTHS	WEAKNESSES
▪ Strong historical background of the valuation system in the Czech Republic ▪ Czech valuers are skilled and educated professionals with high level of practical experience	▪ No regular controlling or auditing mechanisms ▪ Problems with valuation accuracy and variance as an impact of individual valuer
OPPORTUNITIES	**THREATS**
▪ Adopt international valuation standards in order to set and maintain ethical and professional standards and thus assure comparability of valuations across Europe for cross-border transactions ▪ Shift the branch of property valuation in the Czech Republic under the solely control of only one Ministry to bring more transparency in the profession ▪ Adopt clear yet compact definition of market value corresponding to the European valuation practice	▪ The Act No. 36/1967 Coll. on experts and interpreters urgently needs to be revised ▪ The dual price level (regulated administrative prices vs non-regulated market value) – Acts issued by the Ministry of Finance have to be adjusted so that the both prices at least do not differ too much ▪ Neglected cooperation with international bodies such as RICS, TEGoVA and IVSC could lead to isolation of the Czech Republic in context of the EU

Source: [41]

5. Conclusions

This Bachelor Thesis analyses the impact of international valuation standards on the property valuation process in the Czech Republic and whether and to what extent the Czech valuers see a necessity for amendments to the current Czech property valuation legislation in the context of an increasing demand for harmonization of valuation practice within the European Union. The review of the literature focused on purposes for a valuation, valuation methods, individual steps of the valuation process, Czech legal background as well as European valuation standards. Three main drivers for European harmonization in the sector of property valuation (especially concerned with education, valuation methods and practice) were identified, namely the TEGoVA, IVSC, and RICS – the main standards setting organizations with a European scope.

The valuation process of real estate in the Czech Republic is regulated by acts issued by the Ministry of Finance; the valuers' profession as such is controlled by the Ministry of Justice. Even though the relevant valuation basis in the Czech Republic does not contradict the international standards, differences can be identified between the Czech legislation and the relevant international approaches. For market economy it is crucial to determine real market value of property which can be achieved in exchange on the market. Internationally active investors need economic data about individual countries to be consistent, comparable and corresponding to the real market situation. As a result, international valuation standards published by the IVSC, TEGoVA and RICS have been promoted in order to achieve transparency in estimated real values of property. The system of dual price level in the Czech Republic may be suitable for establishing the property transfer tax but not for development of real estate market or entry of foreign investors. The activity of valuers concentrating on market value estimations is creative and joins exact scientific procedures with personal intuition and experience. On the contrary, the work of valuers specializing in administrative price determination is routine. It is difficult to predict further development in the sector of property valuation in the Czech Republic, nevertheless, from the international viewpoint, a change of the system from administrative prices to real market values would be advisable.

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List of Abbreviations

BIS   The Bank for International Settlements

IMF   The International Monetary Fund

IVSC   The International Valuation Standards Committee

OECD   The Organisation for Economic Co-operation and Development

RICS   The Royal Institution of Chartered Surveyors

TEGoVA The European Group of Valuers' Associations

WTO   The Word Trade Organisation

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7.1 Questionnaire

7.2 Questionnaire Results - Detailed Breakdown by Questions

7.1 QUESTIONNAIRE

<u>DOTAZNÍK – LEGISLATIVA UPRAVUJÍCÍ OCEŇOVÁNÍ NEMOVITOSTÍ A CERTIFIKACE ZNALCŮ</u>

Tento dotazník je součástí bakalářské práce „*The Valuation Process of Real Estate in the Czech Republic*" psané na Provozně ekonomické fakultě České zemědělské univerzity v Praze. Dotazník obsahuje celkem 6 otázek a k jeho vyplnění by mělo stačit 10 minut.

Vyplněné dotazníky, ani jejich části, nebudou použity pro jiné účely, než je zpracování pro bakalářskou práci a budou zpracovány anonymně. V případě, že se Vám některá otázka zdá příliš citlivá, nemusíte na ni odpovídat. Pokud budete vyplňovat dotazník v elektronické podobě, vybarvěte prosím příslušný čtvereček jakoukoliv výraznou barvou.

Děkuji Vám předem za Váš čas, který strávíte vyplňováním dotazníku a za jeho doručení zadavateli.

_____

1. Domníváte se, že současný stav, kdy ceny nemovitostí v ČR mají dvojí úroveň – regulovanou a neregulovanou – odpovídá současnému stupni vývoje české ekonomiky? (Odůvodněte prosím.)

   ....

   ....

   ....

2. Domníváte se, že zákon o znalcích a tlumočnících z roku 1967 (č. 36/1967 Sb. a jeho prováděcí vyhláška č. 37/1967 Sb.) je potřebné novelizovat? (Odůvodněte prosím.)

   ....

   ....

   ....

3. Setkali jste se ve své praxi s některým z mezinárodních standardů od organizací RICS, TEGoVA nebo IVSC?

   ☐ Ne   ☐ Ano   ☐ Nevím/nepamatuji se

4. Jste certifikováni podle…?

   ☐ ČSN ISO   ☐ RICS   ☐ TEGoVA

   ☐ Nejsem certifikován/a žádnou z těchto organizací

5. Domníváte se, že je nutné platnou vyhlášku Ministerstva Financí ČR, tj. č. 456/2008 Sb. zásadním způsobem novelizovat tak, aby cena zjištěná více odpovídala ceně obvyklé?

   ☐ Ano   ☐ Ne   ☐ Nevím

6. Domníváte se, že by bylo vhodné v České republice uzákonit některé mezinárodní standardy vydané organizacemi RICS, TEGoVA či IVSC?

   ☐ Ano   ☐ Ne, současný stav vyhovuje   ☐ Nevím

7.2 QUESTIONNAIRE RESULTS – DETAILED BREAKDOWN BY QUESTIONS

Question 1:

Do you believe that the current situation when the real property prices have two levels – regulated and market – corresponds to the present degree of development of the Czech national economy? (Please explain and justify your answer.)

Obtained answers for this first open-ended question can be summarized into three categories:

Number of answers	% share among the 83 respondents	Answers
65	78.31%	The price level should be only one. However, the dual prices level is not unusual in Europe. The regulated prices are commonly applied to moveable assets and services (e.g. tobacco/cigarettes, electrical power). This current situation corresponds to the historical development of price determination even in the market economy in the Czech Republic.
12	14.46%	The dual prices level contradicts the principal assumptions of free trade and should no longer be tolerated in the Czech Republic. Consequently the Acts on administrative price determination issued by the Ministry of Finance should be abandoned.
6	7.23%	Did not comment this question.

Question 2:

Do you believe that the Law on experts and interpreters from the year 1967 (No. 36/1967 Coll. and its implementing Act No. 37/1967 Coll.) needs to be amended? (Please explain and justify your answer.)

Most surprising all (100%) respondents share the opinion that the Law No. 36/1967 Coll., together with its implementing Act No. 37/1967 Coll., needs an urgent revision.

Respondents frequently used similar reasoning for their answers. Considering that this Law was proposed and approved in times of centrally planned economy more than 40 years ago and has been in force ever since, the conditions and definitions used in it are neither acceptable nor actual today. Particularly issues like valuers' remuneration, definitions of valuation sectors in the field of economy, definition of requirements for performing the profession (education, years of practice) have to be overworked.

7.2 QUESTIONNAIRE RESULTS – DETAILED BREAKDOWN BY QUESTIONS
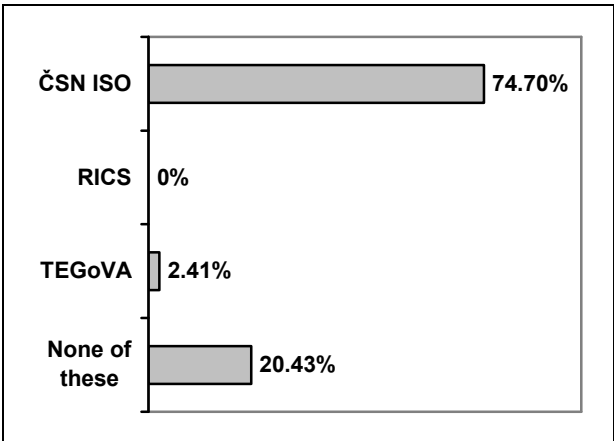
Question 3:

While pursuing your work as a valuer have you ever encountered any international valuation standards published by RICS, TEGoVA or IVSC?
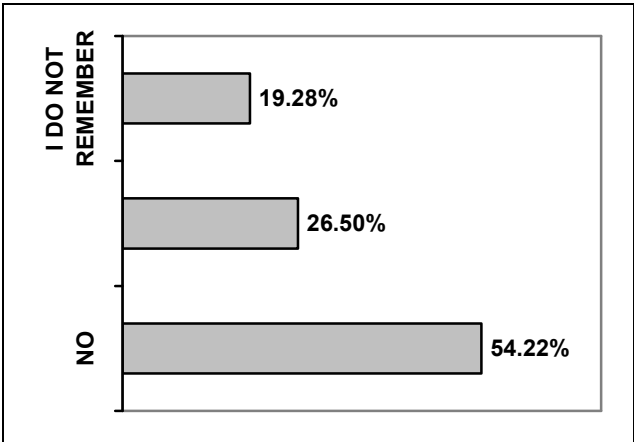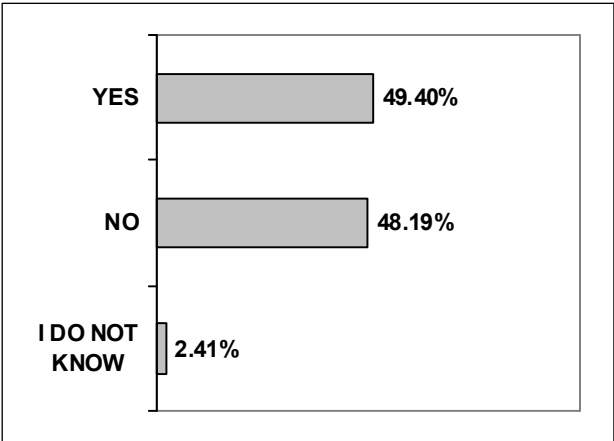

Question 4:

Are you certified by…?

Question 5:

Do you agree that it would be appropriate to fundamentally amend the valid Act of Ministry of Finance No. 456/2008 Coll. in such a manner that the administrative price would more similarly amount to the market value?

7.2 QUESTIONNAIRE RESULTS – DETAILED BREAKDOWN BY QUESTIONS

Question 6:

Do you believe that it would be advisable to legalize the international valuation standards published by RICS, TEGoVA or IVSC and thus make them legally binding for all valuers in the Czech Republic?