



# Highest and best use analysis

**W**e all know that highest and best use (H&BU) analysis is the foundation of any market value estimate, and has an important and practical application within our *Standards* rules. Paying a little more attention to H&BU will better our profession as a whole, and help members prepare improved reports. Through all of this, we will help clients understand the nature of our appraisal or consulting assignments which may result in a reduction in their perceived need to lodge complaints.

The AIC Consolidated Regulations are quite clear in outlining the two goals of our professional practice process. The first goal is to educate our members to prevent reoccurrence of situations that essentially motivate people to complain, and the second goal is to ensure procedural fairness throughout the complaint investigation and the disciplinary process. From time to time, we are asked to investigate complaints that essentially revolve around the matter of H&BU.

**Client motivations** may appear to defy highest and best use determinations, but meet the criteria established by the client. Understanding the owner's intended use for the subject property is a critical step in the art of appraisal reporting. The best time to address this is when you are preparing your letter of engagement and, if necessary, disclose this information in the report, if it is a critical assumption.

A quick reference table based on the *Canadian Uniform Standards of Professional Practice* version dated 01/01/2008 (CUSPAP) has been included as part of this article for future reference. You may wish to consider making a copy for personal use.

This purpose of this article is to discuss an investigation file that provides a practical example of the importance of highest and best use analysis in appraisal practice. In all cases this analysis:

## The *Standards* highest and best use

<b>Definition</b>	2.8: "the reasonably probable and legal use of property, that is physically possible, appropriately supported, and financially feasible, and that results in the highest value."
<b>Appraisal Standard rule:</b>	6.2.13: "state the existing use and the use reflected in the appraisal."  6.2.14: "define and resolve the highest and best use."
<b>Appraisal Standard Comments</b>	7.14: "the use of the real estate existing as of the effective date of the appraisal must be included to distinguish the use from the highest and best use."  7.15: "the report must contain the appraiser's opinion as to the highest and best use of the real estate, unless an opinion as to the highest and best use is irrelevant. If the purpose of the assignment is market value, the appraiser's support and rationale for the opinion of the highest and best use is required. The appraiser's report must be provided in the depth and detail required by the significance of the appraisal, based on relevant legal, physical and economic factors. As land is usually appraised as though vacant and available for development to its highest and best use the opinions are required both as to:  7.15.1.i: the land as if vacant, and;  7.15.1.ii: the property, if improved
<b>Practice notes</b>	12.34.1: "That 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."  12.34.2: "Highest and best use of a property is an economic concept that measures the interaction of four criteria: legal permissibility, physical possibility, financial feasibility, and maximum profitability."  12.34.3: "Estimating the highest and best use of a property is a critical appraisal component that provides valuation context within which market participants and appraisers select the valuation context within which market participants and appraisers select comparable market information."

- informs selection of comparable sales and market value estimates, and

- must meet minimum CUSPAP requirements.

A recent complaint to AIC alleged that an appraisal report completed by a member did not meet the *Standards* because:

- relevant sales and listing history were not reported,
- selection of comparable sales was misleading, and
- market value estimate was too high.

The mission of the Investigating Committee is to complete a fact finding investigation and determine if the member met the *Standards* in the preparation of the appraisal report. The investigation process in this instance determined the following:

- Subject property comprises approximately 59 acres of vacant land, located in an agricultural area, with river frontage.
- Subject property had been listed for sale, within one year of the effective date of the appraisal, on a local Multiple Listing Sale Service for \$285K. The listing expired and the property did not sell. Member failed to check MLS records and was not aware of this information.
- Subject property sold about four months later for approximately \$800,000 to a property developer. The member reported this sales history in the appraisal report.
- The effective date of the appraisal was about six months after the reported sale:
  - highest and best use of property to be short-term holding development property, and
  - market value estimated to be \$1,000,000.
- Intended use of the appraisal was to secure mortgage financing.
- Mortgage loan advance was completed based shortly thereafter.
- About one year later mortgage foreclosure proceedings commenced.
- Lender requisitioned two separate appraisals of subject property and their estimates of market value were significantly lower ranging from \$75,000 to \$335,000.

- Shortly thereafter, lender lodged a complaint with AIC.

**Differences in the H&BU analysis** and selection of comparable sales led to four different market value estimates for the same property.

The listing realtor initially marketed the subject property as a prospective location of a luxury home (estimated H&BU) and it did not sell for \$285,000. However, the same property was then marketed as a potential recreational development property with subdivision potential. Based on this H&BU, it reportedly sold for \$800,000 shortly thereafter, and, based on this H&BU later that year, it was appraised with an estimated market value of \$1,000,000.

Market conditions deteriorated and, about one year later, the same property went into foreclosure. This time, different appraisers did not agree with the former H&BU estimate and selected and used different criteria to select market comparable sales. Their market value estimates were significantly lower.

**Vacant land H&BU analysis** is extremely important in appraisal reporting because the market value estimate depends entirely on the nature of the present or anticipated use for it according to the concept of surplus productivity. The H&BU analysis and underlying assumptions determine the selection of comparable sales and ultimately determine the market value estimate.

The important part of the discussion of this recent file is that the *investigation of the complaint focused on consideration of H&BU analysis* which informed the selection of comparable sales based on the *Standards*.


**Appraisal theory teaches** that the market value estimate of the property will depend on the H&BU analysis and underlying assumptions made by the appraiser and it informs and identifies the selection of comparable properties. The above case study proves this and we all can learn from it.

The importance of going over the fundamentals of H&BU cannot be overstated, nor can it be read by our members too many times. We offer the following points and excerpts from the *Standards* for

your review and consideration as you carry out your professional responsibilities:

**Point #1: Criteria to consider in an H&BU analysis** include first both tests of **legal permissibility and physical possibility**. Only when there is reasonable probability that the H&BU is legally permissible and physically possible can analyses continue.

**Point #2: The test of financial feasibility must be supportable by an analysis of market demand for the proposed land use.** If the net revenue is deemed to be sufficient to satisfy the required market return on the investment and provide a requisite return on the land, the use is financially feasible. **Maximum profitability** is the concept that selects one of the financially feasible uses that produces the highest residual land value and that use is the H&BU.

**Point #3: Feasibility studies are frequently confused with H&BU studies.** Feasibility studies focus on specific investment objectives and criteria established by decision makers to determine whether a given combination of factors meet their minimum investment objectives. 

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