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The cap rate is debated in court because it involves the subjective assessment of the appraiser, wrapped in a statistical analysis to make it appear objective. "Calculation of an appropriate capitalization/discount rate is one of the most difficult, and critical, steps in valuing a business or business interest. It is also a frequently contested area, since there is no single method or formula to arrive at the discount or capitalization rate."[61] The expert will look at external risk factors (like the health of the economy and industry-wide conditions), internal factors that relate to the size, nature, and position of the business being valued, and investment factors like liquidity and expectations for capital appreciation.[62] The expert will often use a "build-up model" to determine the cap rate, which is a formula-based approach that takes the *risk-free rate of return* (the amount an investor would expect from an investment that bears no risk), plus the *expected equity risk premium* (the amount by which investors expect the future return on equity securities to exceed the risk-free rate), the *expected industry risk premium for the industry* (reflecting the relative risk of companies in that industry), the *size premium* (acknowledging that investors expect higher returns on smaller companies), and the *specific company risk for the company valued* (which is subject to appraiser discretion).[63]

"It is extremely important that the analyst maintain consistency between the type of earnings and the capitalization or discount rates used in the valuation process. For example, a pre-tax rate should not be applied to net income because net income is assumed to be stated on an after-tax basis. This is a very simple distinction. However, often this distinction is overlooked in the valuation of a closely held business, thereby significantly over-valuing or under-valuing the business."[64]

Another common error is to use a growth rate that depends on future capital investments by the company to achieve those earnings.[65] This is usually revealed on cross-examination as an unstated assumption, which makes the expert's valuation worthless or requires an adjustment for the money that would have to be spent to yield those returns. The assumed growth rate for the company is also subject to manipulation when arriving at the cap rate. The idea behind the capitalization-of-earnings method is to base the valuation conclusion on the long-term, sustainable earnings that the company can produce.[66] But some experts will use aggressive rates of return when conducting the build-up analysis, to overstate the value.

CONCLUSION

Statistics are powerful when used by someone who understands them, making a sea of data understandable. But when misused, the persuasive power of numbers can overcome common sense and make us believe results that did not happen. When complex issues like the valuation of a business are litigated, a statistic can make a large difference in the outcome. With a basic understanding of statistics, we can ensure that decisions are made according to reliable information and expose tricks with numbers.

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61. National Association of Certified Valuators and Analysts (NACVA), *Ch. 5: Capitalization/Discount Rates* in Fundamentals, Techniques and Theory (2012), http://edu.nacva.com/preread/2012BVTC/2012v1_FTT_Chapter_Five.pdf (last visited Mar. 10, 2022).
62. *Id.*
63. *Id.*
64. *Id.*
65. *Id.*
66. *Id.*

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