



Forensic & Valuation Services, PLC

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Fo-ren-sic adj \fə-'ren(t)-sik, -'ren-zik\ Accounting & Economics Note Card

The Numbers, Studies and Statistics Behind a Personal Injury or Wrongful Death Economic Damages Analysis

Note Card # 5 - March 2013 Discount to Present Value

If you missed a previous Note Card, email us and we will be happy to forward you a copy: rvance@forensicval.com

In Note Card #1, we listed the *Essential Elements* of a PI/WD Economic Damages Analysis:

- 1) **Loss of Earning Capacity** that would have been earned as occupational compensation, less mitigating earnings still able to produce, if any
- 2) **Loss of Fringe Benefits** that are part of the occupational earning capacity
- 3) **Loss of Household Services** that would have been performed, less the value of services still able to perform
- 4) **Medical & Rehabilitation Bills** incurred in the past plus estimates of future bills from a Life Care Plan
- 5) **Discount** all four loss elements **To Present Value**, usually to the Trial or Mediation Date

Essential Element 4, Medical & Rehabilitation Bills, is fairly straightforward in that the forensic economist takes projected costs and frequencies from a Life Care Planner and extends them out using a Medical CPI, then discounts to present value. Not a whole lot to explain in the Note Card Series, so we jump to:

Essential Element 5, Discount to Present Value

Damages are calculated to the present value so as to quantify a stream of payments into a single, lump-sum figure for settlement or award purposes. The stream of payments consists of the Essential Elements 1-4: Loss of Earning Capacity, Loss of Fringe Benefits, Loss of Household Services and Medical and Rehabilitation Bills. The stream is discounted and a "haircut" is taken from the gross amount since the payments are all hypothetically received today rather than having to wait for them over time, plus the risk of not receiving the payments is

removed, thus the concept of *the time value of money*. In other words, a bird in the hand. The damage elements are separated into pre-trial (from date of injury to trial date) and post-trial (from trial date to end of worklife expectancy and/or life expectancy).

The present value of the future, post-trial payments is the amount it would take, if invested today with interest compounding to equal the amount of the payments at the point they are to be made. Similarly, the present value of past, pre-trial payments is the amount it would have become today had it been invested at the point it would have been made or earned. In some cases, interest is added to pre-trial figures to account for the loss of use of the funds since time has already passed and to present value the figures into today's dollars. Some argue that is pre-trial interest and should not be added.

The discount rate is quoted as a rate of interest, usually from what is known as a "safe" rate. The term "safe" refers to "the rate of interest that would be earned on 'the best and safest investments.' Once it is assumed that the injured worker would definitely have worked for a specific term of years, he is entitled to a risk-free stream of future income to replace his lost wages; therefore, the discount rate should not reflect the market's premium for investors who are willing to accept some risk of default." [JONES & LAUGHLIN STEEL CORP. v. PFEIFER, 462 U.S. 523 (1983)].

The most common source for a safe rate is U.S. Treasury Bonds - but the question is: what term do you use? The longer the term of the bond, the greater the interest rate. For instance, as of March 22, 2012, 90 day bonds were paying at .07%, 10 year at 1.93% and 20 year at 2.75%. **As the rate increases, the discount increases thus lowers the lump-sum, present value damage figure.** I usually attempt to match the projection period with the bond term, thus use the 20 year bonds in most circumstances. The rate is usually one of the major discrepancies in opposing expert reports and can create a large difference in the figures.

Some forensic economists will use the *Constant Dollar Method* wherein the inflation rate is removed from projected loss of earning capacity and is removed from the safe rate used to discount future dollars to present value. Utilization of this method makes the discount rate appear to be less, but if inflation is removed from the income and the discount rate, the end result should be the same as if the inflation was never removed. This method often confuses attorneys since it makes it appear that opposing experts may have used very different discount rates, when, in fact, they are essentially the same.

More on each one of the remaining elements in future Forensic Accounting & Economics Note Cards

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