VALUATION

Correctly Calculating the Present Value of Future Medical Costs in Personal Injury Cases

By Henry Fishkind, PhD; and Byron Walden, CPA, CVA, MBA

Calculating the present value of future medical costs in personal injury (PI) cases is both necessary and can sometimes be difficult. The calculations involve three key sets of analyses: (1) a life-care plan estimating the future costs for medical and life-care services for the injured party; (2) a forecast for rates of medical and life-care cost inflation over the same period of time as the expected services; and (3) the calculation of an appropriate discount rate to reduce the future trajectory of medical and life-care costs to their present value. We highlight each of these issues in this short article.

THE LIFE-CARE PLAN

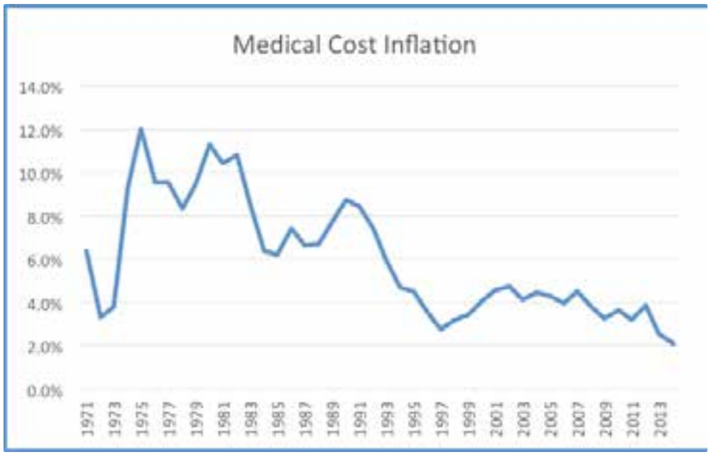
The components of the life-care plan and its base year costs are determined typically in an expert report authored by a competent life-care professional. Based on the components of the life-care plan, the life-care expert typically prices out the plan for the base year from a variety of sources generating price ranges for the medical procedures, devices, medications, and other elements of the plan. Generally, these prices reflect only the "rack" rate, or retail rate, rather than the reasonable and customary charges actually paid by a consumer or their insurance company. It is well established that most reasonable and customary prices are heavily influenced by Medicare reimbursement rates, which tend to be significantly lower than the retail rate set forth in the reference media used to price most life-care plans. This difference between retail/"rack rates" and customary rates can be an important consideration in accurately calculating the present value of a life-care plan.

MEDICAL AND LIFE-CARE COST INFLATION

The life-care plan typically includes base-year costs for all of its components. The economic expert must estimate the future rates of medical and life-care cost inflation. Since the plans often have lengthy future horizons (twenty to forty years is typical for many plans), economists often utilize a look-back period of thirty years or more in order to estimate future medical inflation. In many cases, the past can be informative when making estimates of the future.

However, in the case of medical inflation, the data as shown in Figure 1 demonstrate a structural change that began around the year 2000 and continues through to today. The annual rate of medical inflation was approximately 7.1 percent between 1971 and 1999 based on data from the U.S. Bureau of Labor Statistics Consumer Price Index. Between 1985 and 1999 the average dropped to 5.8 percent. From 1985 through 2014 the average was approximately 4.8 percent, and from 2000 through 2014 the average dropped further to 3.8 percent. Notably, the annual rate of medical cost inflation for 2014 is only 2.1 percent, the lowest annual rate since at least 1971.

FIGURE 1: MEDICAL COST INFLATION USING THE CPI FOR MEDICAL COSTS



The data point to a permanently lower trajectory for medical cost inflation. Finally, although it is still too early to fully gauge the impact of the Affordable Care Act (ACA) on medical cost inflation, it is important to recognize that the ACA is designed in part to reduce medical cost inflation in the long run. The upshot is that it is more appropriate to estimate the future rate of medical cost inflation using the data from 2000 to the present rather than using the older data, which reflect a different and higher medical cost inflation environment.

THE DISCOUNT RATE

Finally, the economic expert must calculate the discount rate used to reduce the future stream of costs for the life-care plan to its present value. A properly calculated discount rate reflects the following considerations: (1) the need to provide the injured party with the funds necessary to pay for the life-care plan with certainty; and (2) any uncertainty encompassed in the life-care plan. There is obvious tension between these two factors. Economists generally consider only the first one and neglect considering the risks associated with the cost estimates for the life-care plan.

Continued on page 35

as a reviewer and interpreter of valuation reports prepared by third parties. My deliverable will be a customized report/checklist pointing to critical valuation metrics, including the experience and qualifications of the valuator, and providing an overall assessment of those metrics for reasonableness. This will save trustees time and provide an added layer of protection to document their due diligence process.

FLPs and Other Smaller Engagements. In my experience, there are certain engagements where a site visit is not necessary. Among these are FLPs that hold marketable securities or real estate and calculations of value for very small operating entities. An example of the latter is a small family owned business in which the shareholders want to document gifts up to the annual exclusion amount. Faced with fees that, given the size of the gifts, did not make economic sense, business owners often forgo a valuation. To create an opportunity to educate the client and her advisors, I have worked hard to develop a lean process for small calculations of value… from the first conversation, to the engagement letter, to my Excel template and report, and then wrapping up. For what I formerly charged, $4,000–$5,000, thereby pricing myself out of the market in most cases, I now deliver quite profitably for $2,500. Of course, I carefully consider when such a service is appropriate.

In addition to developing and focusing on engagements I enjoy performing, I'm working on removing geographic barriers for providing my services. This will allow me to leverage social media and reduce out-of-office business development time. It will also allow me to design the lifestyle I desire as well as create opportunities for others.

In my next installment, I will discuss how I am currently working with other professionals and some concepts I am exploring in that regard. Until then, best wishes. VE

Continued from page 25

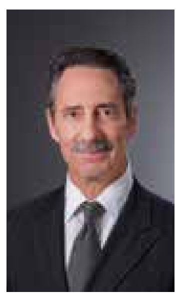
CONCLUSION

While it is vital to fully compensate an injured party in PI matters, the reality is that life-care plans are long-term forecasts for medical and life-care needs, which are subject to the vagaries of the future and could ultimately be in error. In addition, future projections for medical costs are also uncertain. Stated differently, an injured party deserves full compensation, but the precise value for that full compensation can only be estimated with considerable uncertainty and admitted imprecision.

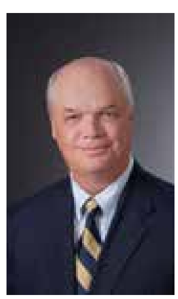
These considerations suggest a two-part determination for an overall discount rate: (1) a risk free rate of interest consistent with the horizon of the life-care plan; and (2) a risk-based analysis of the precision of the life-care plan and the injured party.

In addition, it is useful to remember the obvious, the discount rate must reflect the time value of money to both the plaintiff and the defendant. The plaintiff benefits from an accurately calculated present value amount, because it takes into account both the uncertainty of receiving future amounts and future price inflation. Further, a dollar today is worth more than a dollar received in the future, which adds extrinsic value to the amount received by the plaintiff. The defendant benefits, because they are relieved of the burden and uncertainty of making a stream of monthly payments across time given the associated variables.

One of the mistakes we have witnessed is the use of higher historical inflation rates and a lower discount rate based on current bond yields. This is done in the interest of ensuring the plaintiff can invest the proceeds in a risk-free instrument to generate the future values identified in the life-care plan. The error is that such a discount rate does not reflect any risk other than the time value of money, thereby overstating the present value to the plaintiff creating a windfall. Plaintiffs should be treated fairly, but it is our opinion that too many practitioners fail to adequately account for the inherent uncertainty of life-care plans in calculating present value awards for plaintiffs. This practice could result in inflated awards to plaintiffs or inequitable results for defendants. VE



Henry Fishkind, PhD, began his career in the public sector where he worked as an economist and associate professor at the University of Florida. In 1980, Dr. Fishkind became the associate director for programs at the University of Florida's Bureau of Economic and Business Research. During his tenure at the university, Dr. Fishkind served from 1979–1981 on the governor's economic advisory board. In 1988 Dr. Fishkind founded Fishkind & Associates, Inc, as a full service economic and financial consulting firm.



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