DISCOUNTING DAMAGES: HOW A DOLLAR TODAY IS WORTH MORE THAN A DOLLAR TOMORROW

When it comes to calculating economic damages in legal cases, financial experts are tasked with discounting lost profits to their net present value. But determining the appropriate discount rate can be a complex process that requires a deep understanding of market conditions and the risks associated with a particular business or product.

The concept behind discounting damages is simple: a dollar today is worth more than a dollar tomorrow. This is due to the time value of money, which recognizes that money is worth less the longer you must wait to receive it. By discounting lost profits to their net present value, financial experts can account for this difference in value over time.

But even a small difference in the discount rate can have a significant impact on the expert's conclusion. That's why it's crucial to determine the appropriate loss period and discount rate based on the specifics of the case at hand.

Duration of losses

To determine the relevant loss period, the expert must first assess the length of time over which the plaintiff experienced losses. This could be the term of a contract, the useful life of a product or the amount of time required for the plaintiff to reasonably mitigate losses. Undiscounted lost profits represent the difference between the plaintiff's expected profits "but for[SES1] " the alleged legal violations of the defendant and the plaintiff's actual profits.

The expert then uses discount rates to compute the present value of lost profits from each month or year. Each period's discounted losses are combined to arrive at the net present value of lost profits. Discount rates must accurately reflect the time value of money and the risks associated with the business or product, including uncertainty around the actual achievement of projected profits.

Discount rate

There are several factors that go into determining the appropriate discount rate, including the assumed rate of return and the risk factor. If the company has a consistent earnings history and is likely to achieve its projected future earnings, a lower rate of return may be appropriate. Relevant case law, contract terms, and the lawsuit's context should also be considered but never as the primary or sole support for calculations.

Common rates chosen by experts include the safe rate or Treasury rate, the cost of equity, the cost of debt, and the weighted average cost of capital, or WACC (see below). [SES2] [BDP3]

Common rates chosen by experts include:

Safe Rate

The so-called safe rate, or Treasury rate, is often a good starting point. It reflects inflation and a “rental rate” for the use of funds.

Cost of Equity

A financial expert can determine the cost of equity using one of several build-up methods or the capital asset pricing model, which considers market, industry and company-specific risks. The discount rate may begin with the Treasury rate and increase based on risk, using stock market benchmarks and qualitative assessments of the plaintiff’s operations.

Cost of Debt

The use of this discount rate presumes that the plaintiff’s borrowing rate approximates both the time value of money and the risks the plaintiff faced in the absence of an injury.

Weighted Average Cost of Capital (WACC)

The WACC represents a weighted average of the returns paid to debt and equity holders for their investments, based on the costs of equity and debt.

A difference of just one percentage point in the discount rate can result in a difference of over $100,000 in the present value of a stream of cash flows over ten years. This shows how crucial it is to get the discount rate right to arrive at an accurate estimation of economic damages.

The following chart shows the present value of $1,000 for ten years at different discount rates:

Discount Rate	Present Value of $1,000
5%	$613
7%	$508
9%	$422
11%	$349
13%	$288

As the chart shows, the higher the discount rate, the lower the present value of a future sum of money. Ultimately, selecting an appropriate discount rate is just as critical as quantifying projected losses. Subtle changes in the discount rate can have a major impact on an expert's conclusion. An experienced financial expert knows how to develop a discount rate that's supported by objective market data.

Experience counts

In conclusion, discounting damages to their net present value is a crucial part of calculating economic damages in legal cases. The appropriate loss period and discount rate must be determined based on market conditions and the risks associated with the business or product. By working with an experienced financial expert, attorneys can ensure that their clients receive accurate and fair compensation for their losses.