

DISCOUNTING

Due to the level of inflation money tends to deteriorate in value over a period of time. For example, the value of £1 now is likely to be less than the value of £1 in 3 years' time.

Imagine we had £100 now (time 0) and invested it in an interest earning account at the rate of 10%. It would grow as follows:

TIME	VALUE
0	100
1	110
2	121
3	133

This is known as compounding the figure.

The formula for the compound factor is $(1 + r)^n$

Conversely, if we wish to know the value in today's terms of £133 (this is the present value) payable in 3 year's times, we can calculate this using a discount factor.

The discount factor formula is $\frac{1}{(1 + r)^n}$

r = rate of interest / discount rate.
 n = number of years.