The compounding effect in financing, the npv value technique

Finance

DQ1

The compounding effect is one of the oldest concepts in the financial world. Compounding is a powerful concept because it allows for the creation of money. Compounding works in the following manner. If you put $1000 in a bank account paying 5% the money will grow by 5% after one year and the following year the account will increase by 5% of the principal plus the interest accumulated which would be 5% of $1050 and so on. Compounding has a reverse effect which is referred to as discounting. Discounting is used to determine the time value of money of a fixed amount of money or expected cash flow; for instance, if a person has $500 that money will be worthless in the future because money depreciates due to the effect of inflation. Based on the time value of money present value table $500 discounted at 3% will be worth $431. 30 five years from now (Besley & Brigham, 2000).

DQ2

The way to calculate the present value of the amount of money is by using financial calculators. Graphic calculators such as the Ti-89 titanium have integrated financial calculators in its systems which are very easy to use. The discounting rate a company uses depends on the risk the company is willing to take. Some companies require a higher discounting rate than others due to the industry in which they operate.