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# Discounted Cash Flow Definition

Discounted cash flow analysis is a method used to value securities that incorporates the time value of money.

$100 next year is not worth as much as $100 today.

If we have $95 today and buy a one-year CD yielding 5.26%, in one year we will have $100.

$100 next year is the same to us as $95 today. The $100 has been discounted to today's value.

$100 in two years is only worth $90.25 today because we must discount the value twice.

And so on for each successive year.

In stock valuation we estimate a company's future earnings year by year and discount them to the value today. The sum of these values is the theoretical stock price. (The accuracy of our estimates is also very important!)

The discount rate is tied to current interest rates. A lower discount rate leads to higher stock values because future earnings are not discounted as much.

Using the example above, if the discount rate was 4% instead of 5.26%, $100 next year would be worth $96.15 today.