

# APPLIED FINANCE

Lecture 1

# CONCEPT OF FINANCIAL MANAGEMENT

## What is Finance

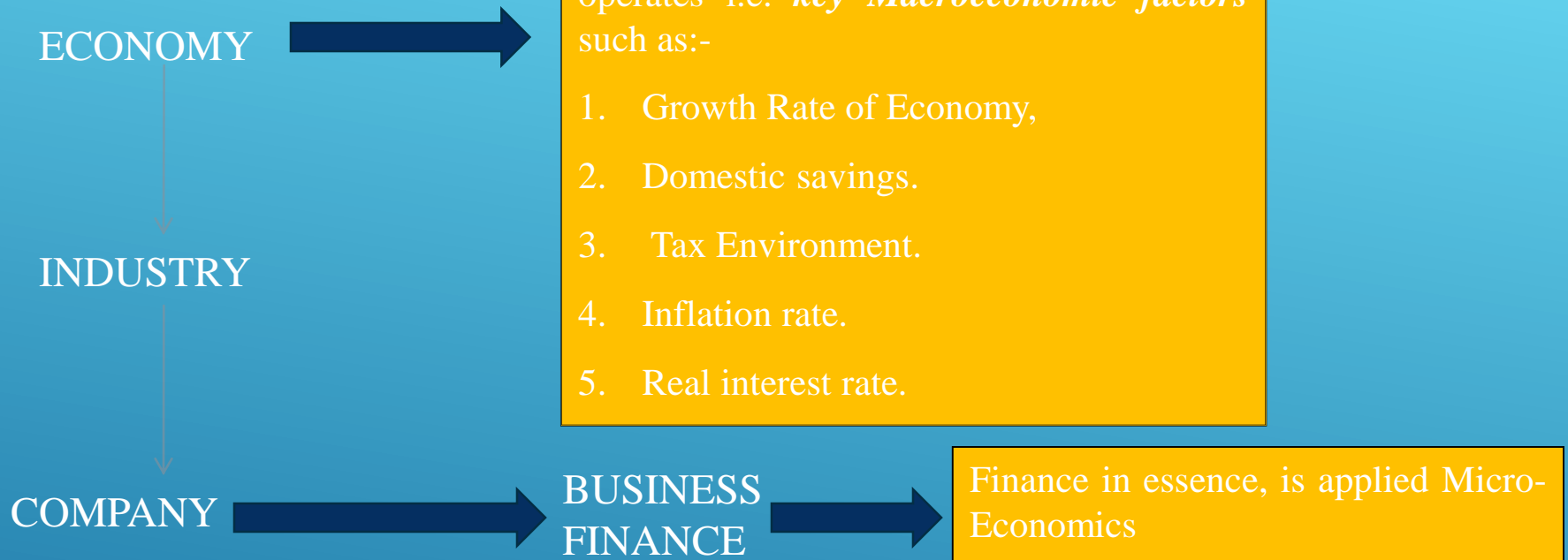
1. SUB-SET OF ECONOMICS AND IN ESSENCE IS ALSO TERMED AS APPLIED MICRO-ECONOMICS.
2. IMPORTANT BUSINESS ACTIVITY.
3. FUND MANAGEMENT SCIENCE.
4. FOCUSES IN WEALTH MAXIMIZATION GOAL/ENHANCING FIRM'S VALUE.
5. FOCUSES ON FUTURE DECISION BASED ON ACCOUNTING FINANCIAL STATEMENTS.
6. ALSO REFERRED AS CORPORATE FINANCE OR MANAGERIAL FINANCE.

## BASIC CONCEPT OF NATIONAL INCOME AND ECONOMIC INDICATORS

1. GDP: A measure of the final goods and services, produced by the residents of the country with resources located in that country.  $GDP=(C+I+G)+(X-M)$  {Domestic Economy}; 5.3% India's GDP growth during Jan-March 2011-12, slowest in 9 years.
2. GNP: The value measured at market prices, of all final goods and services produced by an economy in one year.  $GNP=(C+I+G)+(X-M)+(R+P)$  {Open Economy}
3. IIP: Index of Industrial production, released monthly, is a measure of capturing production across factories in India. It records output in factories across three categories-mining, electricity, manufacturing, IIP was flat at 0.1% in April.
4. WPI: Wholesale price Index; This is India's most watched cost of living index. Calculated on a monthly basis, the index gives trends in inflation rate or the rate at which wholesale prices of goods such as vegetables, fuel, manufactured items and food grains are changing. It rose to worrisome 7.55% in May.
5. CPI: Consumer Price Index; released monthly, gives retail prices of almost all everyday products and services from food to footwear and movie tickets to medicine. It is more realistic cost-of-living index because it captures shop-end prices. It rose 10.36% in May, showing government inability to cool prices.
6. Sensx: The Bombay Stock Exchange's (BSE) benchmark 30-share index (reflects the weighted arithmetic average of price relatives of 30 sensitive shares) is a barometer for equity markets, perhaps the first indicator (base year for calculation of sensx is 1978-79; value 100) about the health of the economy and investor sentiments. The Sensx closed up 76 pts. at 17,538.67 on Thursday (5<sup>th</sup> July), a three-month high, amid strong expectations about reformist moves in the coming weeks.

# SUB-SET OF ECONOMICS

The fundamental Approach says



Defines the environment in which the firm operates i.e. *key Macroeconomic factors* such as:-

1. Growth Rate of Economy,
2. Domestic savings.
3. Tax Environment.
4. Inflation rate.
5. Real interest rate.

Finance in essence, is applied Micro-Economics

*key Microeconomic tools*

principal of marginal analysis according to which a decision should be guided by a comparison of incremental Benefits and Cost

1. *Economics Focuses on optimization of Valued Goals.*
2. *Finance Focuses on Wealth Maximization*
3. *To Sum up, a basic knowledge of macro-economics is necessary for understanding the environment in which company/firm operates.*
4. *Good grasp of micro-economic principles is helpful in sharpening the tools of financial decision making*

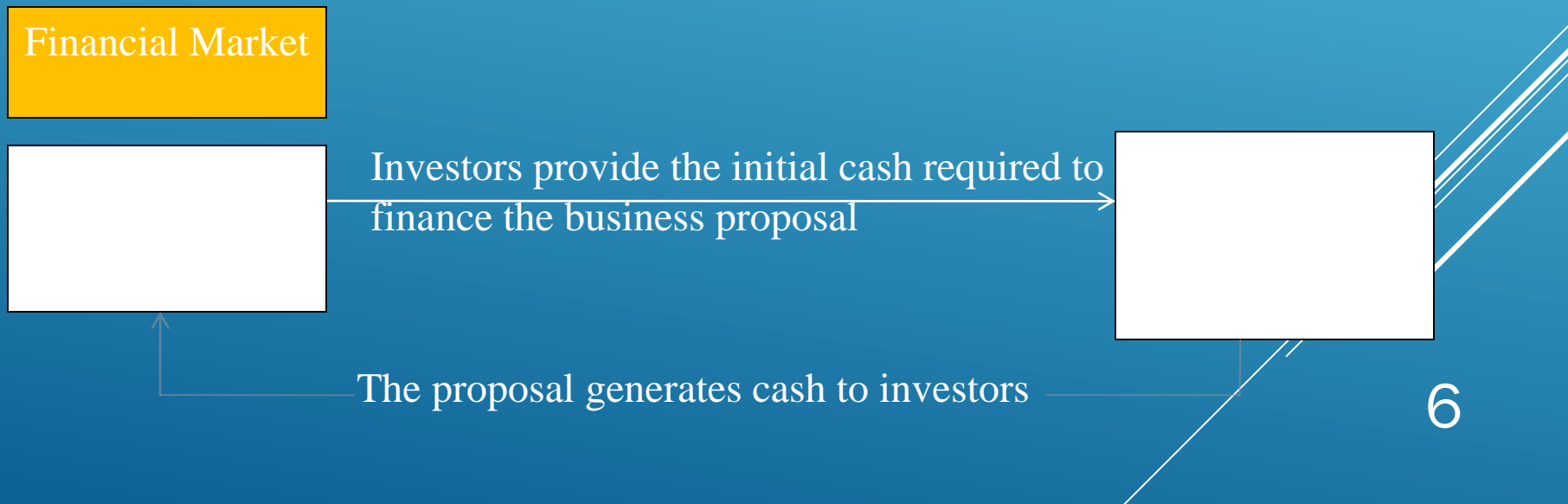
# IMPORTANT BUSINESS ACTIVITIES

Major Business Activities in a Firm is categorized as:-

1. PRODUCTION
2. MARKETING
3. **FINANCE**

# FUND MANAGEMENT SCIENCE

1. CHOICE OF FINANCIAL MARKET
2. CHOICE OF FINANCIAL INSTRUMENT---FINANCING DECISION
3. OPTIMUM CAPITAL STRUCTURE DECISION
4. OPTIMIZATION OF COST OF CAPITAL



# FUND MANAGEMENT SCIENCE

## FINANCE FUNCTION



**FINANCING  
DECISION**



**INVESTMENT  
DECISION**

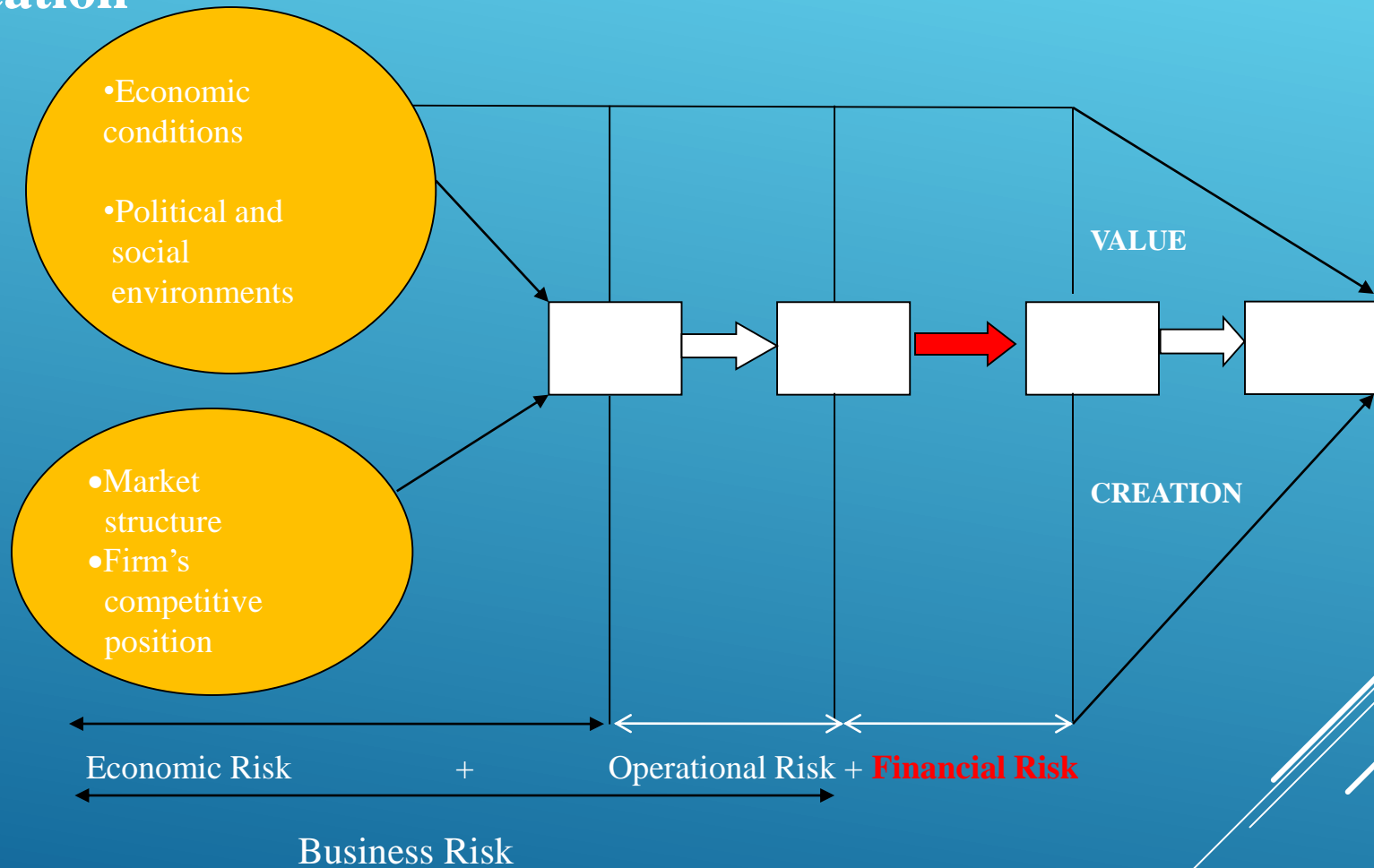


**LIQUIDITY  
DECISION**

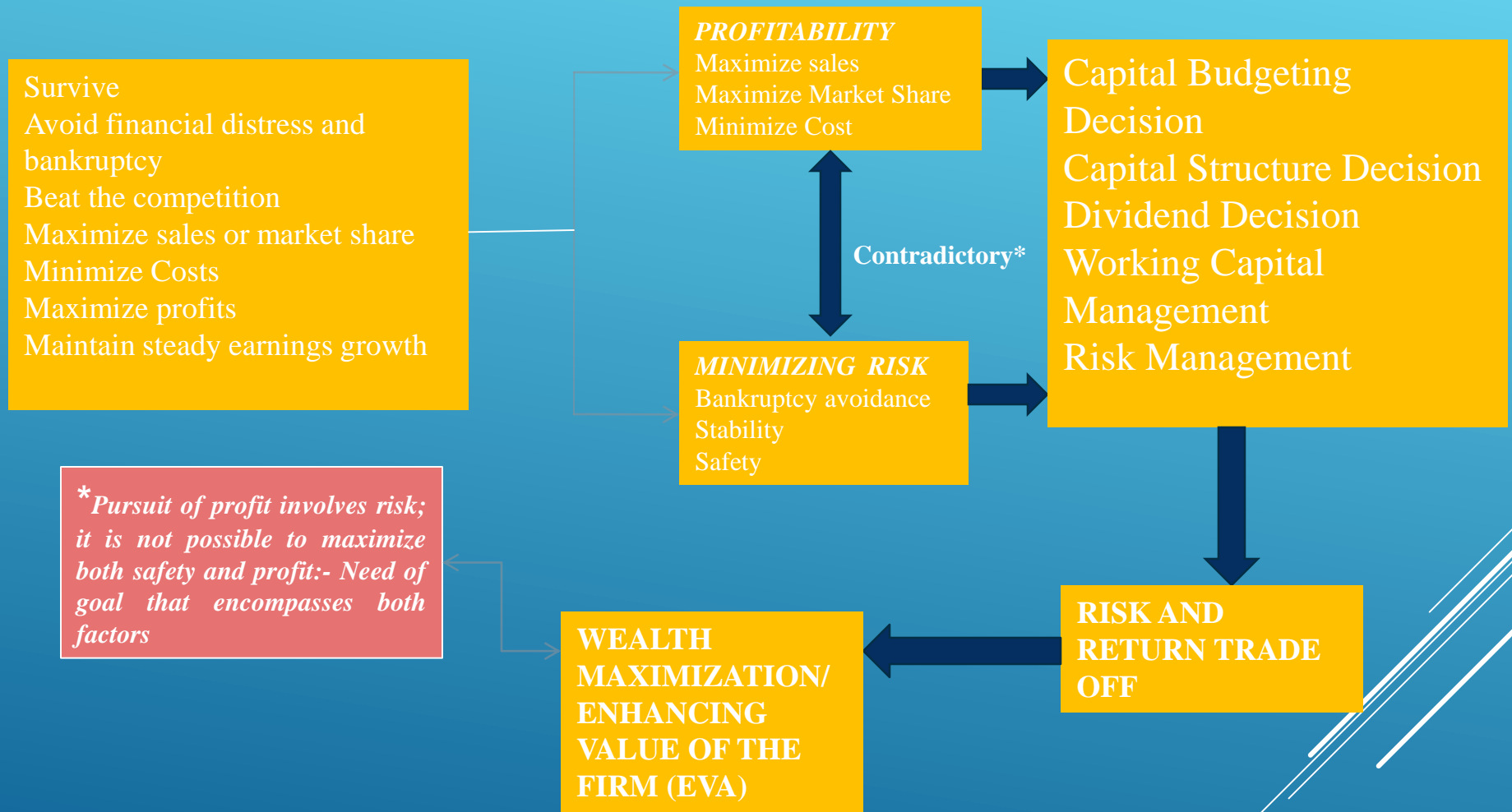
1. Investment or Long Term Asset Mix Decision
2. Financing or Capital Mix Decision
3. Dividend or Profit Allocation Decision
4. Liquidity or Short Term Asset Mix Decision

# FOCUSES IN WEALTH MAXIMIZATION

## GOAL/ENHANCING FIRM'S VALUE -The process of value creation



# RISK-RETURN PARADOX



## FOCUSES ON FUTURE DECISION BASED ON ACCOUNTING FINANCIAL STATEMENTS

- Share Capital
    - Equity
    - Preference
  - Reserve & Surplus
  - Secured Loans
    - Debentures
    - Loans and advances
- Capital structure and Cost of Capital

- Unsecured Loans
  - Current Liabilities and Provisions
    - Trade Creditors
    - Provisions
- Working Capital financing policy

- Fixed Assets (net)
    - Gross block
    - Less: depreciation
- Capital Budgeting

- Investments
- Portfolio Management

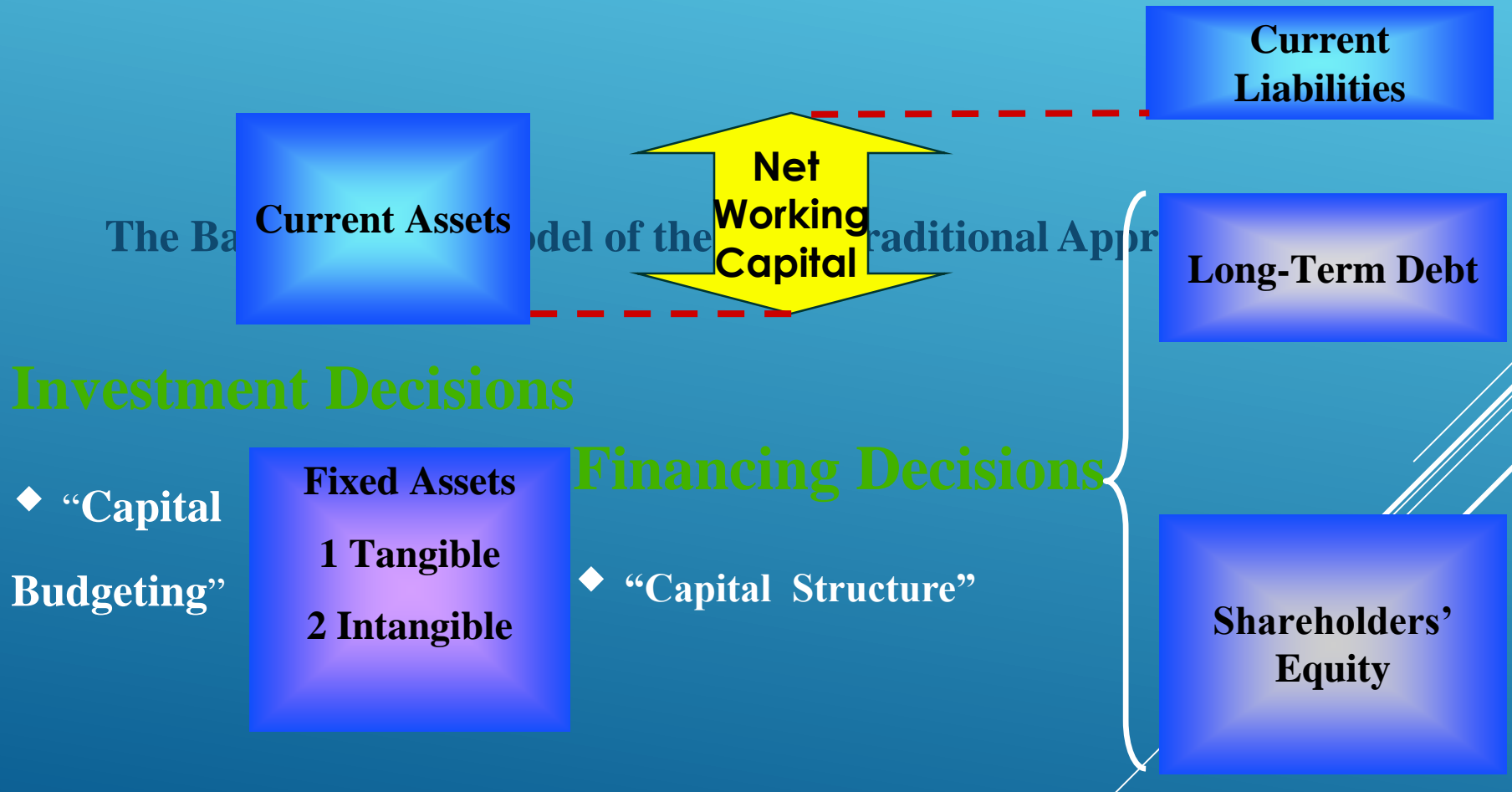
- Current Assets, loans and advances
    - Cash and bank
- Cash Management

- Receivables
- Credit Management

- Inventories
  - Miscellaneous expenditure and losses
- Inventory Management

ALSO REFERRED AS CORPORATE FINANCE OR MANAGERIAL FINANCE  
THE ROLE OF THE FINANCIAL MANAGER

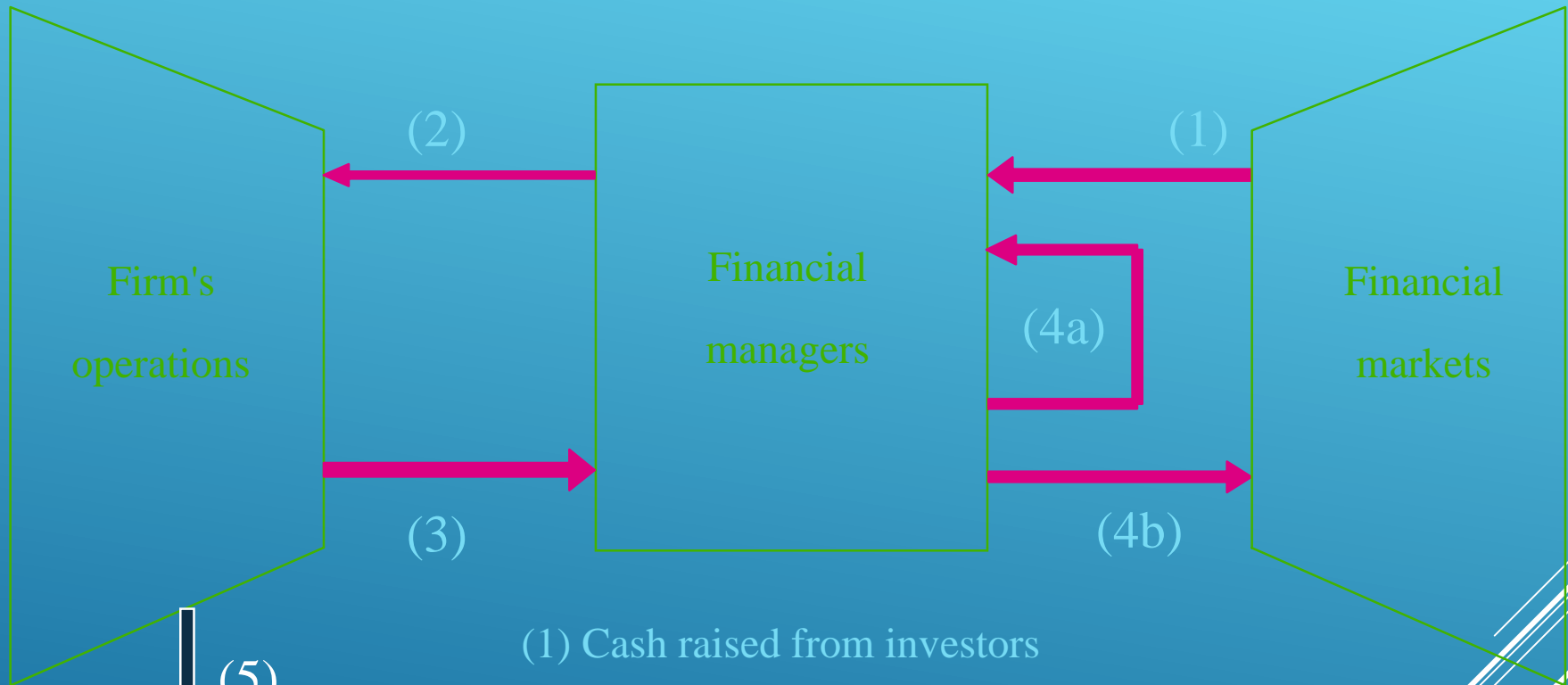
## The Net Working Capital Investment Decisions



## FOCUSES ON FUTURE DECISION BASED ON ACCOUNTING FINANCIAL STATEMENTS



**ALSO REFERRED AS CORPORATE FINANCE OR MANAGERIAL FINANCE  
THE ROLE OF THE FINANCIAL MANAGER**



- (1) Cash raised from investors
- (2) Cash invested in firm
- (3) Cash generated by operations
- (4a) Cash reinvested
- (4b) Cash returned to investors
- (5) Taxes

Government

## ALSO REFERRED AS CORPORATE FINANCE OR MANAGERIAL FINANCE THE ROLE OF THE FINANCIAL MANAGER

### Contemporary Approach

- ▶ Concern on **Institutional Imperatives** referred as the focus which lead to divergence between the goals of Managers and Shareholders. Instead of merely focusing on the efficient allocation of funds among various assets and the acquisition of funds on favorable terms.
- ▶ A fundamental change in financial management is the direct result of two recent trends: the **Globalization of Competition** and the **Integration of World financial markets** facilitated by **Improved ability to collect and analyze information.**
- ▶ A common element, which distinguishes the recent Financial Management tools from the earlier ones have emerged predominantly *from practice and from consultants.* **The modern approaches also have developed concerning the pursuit of shareholder value.**

**ALSO REFERRED AS CORPORATE FINANCE OR MANAGERIAL FINANCE  
THE ROLE OF THE FINANCIAL MANAGER**

**Competencies**

**Business Knowledge**

**Effective Costing, Planning & Evaluation**

**Risk Management**

**Standards Compliance**

**Effective Communication**

**Performance Management**

**Forecasting, Planning and Budgeting**

**Accounting/ Financial Knowledge**



**Valued-added  
Advice**



**Strategic  
Focus**



**Value-  
for-  
Money**

THANK YOU