The 3A's of Finance

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Asma Rafique Chughtai
asmarafique@vu.edu.pk

What is Finance? Is it about arranging funds or is it concerned with forecasting business needs? Does it include distribution of pooled funds or it is concerned with accumulation of funds only? Due to all these ambiguities, finance and the activities it covers is perceived as complex. If you are having the same bafflement then do not get upset. This document will help you in building your concepts about what finance comprises.

Financing is simply the sum of 3A's. These are:

1. **Anticipation**
2. **Acquisition**
3. **Allocation**

Now let us have a look at what these 3A's mean. We will begin with Anticipation.

Anticipation -being the core of finance- refers to identifying/predicting future financial needs. It requires looking not only at the future perspective but towards the past as well. Having an insight at past enable business entities to seek guidance from mistakes encountered in the past and to avoid those mistakes in the future. The question which arises is how to envisage future needs. Well, it is by looking at both *short term* as well as *long term goals* of the business.

Short term goals comprise the quest to have immediate profits, satisfying stakeholders and cost reduction. On the other hand, long term goals are inclined towards expansion of business through investment in new projects, ventures and investments. Moreover, the need to have funds for meeting contingencies cannot be ignored. This is where the need of budgeting starts.

Anticipating the sources required for short and long term goals achievement cannot be achieved without proper budgeting. *Budgeting* includes making a road map for allocation of funds aligned with business future objectives (short term and long term) keeping in view the previously applied budgets and incorporating the amendments (where required). However, to decide optimal investment in new projects, ventures and vehicles, organizations use the renowned techniques of *Capital Budgeting.*

Capital budgeting refers to anticipating and identifying business opportunities and to invest in the best alternative available. These techniques include Payback Period, Net Present Value (NPV), Internal Rate of Return (IRR), Profitability Index, Cost benefit ratio, etc. Financial analysts use these techniques to decide whether it is wise to invest the entity's funds in intended investment opportunity or not. Moreover, a quick glimpse of macro factors on which an entity depends either directly or indirectly cannot be ignored such as industry structure, business life cycle phase, national and international factors related to industry, trade and commerce.

"Successful investing is anticipating the anticipation of others."
(John Maynard Keynes)

Once the future financial needs have been identified and screened, the role of **"Acquisition"** (being the second A of finance) starts.

Acquisition refers to the accumulation of funds/sources required to fund the financial needs encountered as per the anticipation. Once future financial needs have been anticipated, the next point of concern to the financial managers is how to acquire money for financing the continued business operations and intended projects.

We are very well aware that there are two major sources of funds available to the organizations. These are *Debt and Equity*. Generally organizations use these two sources in a blend i.e. combination. It is primary because of potential benefits associated with both these sources. This mixture is referred to as *Capital Structure.*

Usage of leverage/debt (an external source of funds) provides organizations with tax shield by means of reduction in taxable profits due to financing costs of debt. On the other hand, using equity (an internal source of funds) provides companies' with exposure to growth opportunities by means of re-investment of profits without financial obligations. Therefore, organizations prefer to make a tradeoff between debt and equity as per the requirements.

Debt providers include banks, DFIs, financial institutions and personal relationships. Besides this various debt tools are also available such as bonds, debentures and money market instruments. On the other

side, equity financing is the accumulation/acquisition of funds by issuing shares to the public. Listed companies also trade these shares in capital market i.e. *Stock Exchanges*.

Once an entity acquires sufficient capital to finance its working capital and expansion needs, the next step is the **Allocation** of these sources.

Allocation refers to the systematic distribution of pooled sources as per the decided budget. Asset allocation is further divided into two types i.e. **Strategic Asset Allocation** and **Tactical Asset Allocation**.

Strategic asset allocation is allocating money among various assets classes and investment projects. This is done by keeping in view the planned scheme of investments as well as company's long term goals. However, **T**actical Asset Allocation is intended at getting benefit from short term opportunities that may arise during the various stages of business life cycle. A nominal fund is usually set aside by corporations in order to invest in abrupt profitable opportunities. This is referred to as tactical asset allocation. Organizations that successfully indentify and avail such short term abnormal business opportunities usually take lead among the peer groups.

It is pertinent to mention that these 3A's must be in same order/sequence otherwise the essence will be completely lost. For example, acquisition cannot be done before anticipating the need.

Summing up, financing is nothing more than combining 3A's together i.e. **A**nticipation, **A**cquisition and **A**llocation i.e. predicting future needs, acquiring the desire sources of funds and their distribution as per the budget.