Book Review: How Finance Works: The HBR Guide to Thinking Smart about the Numbers

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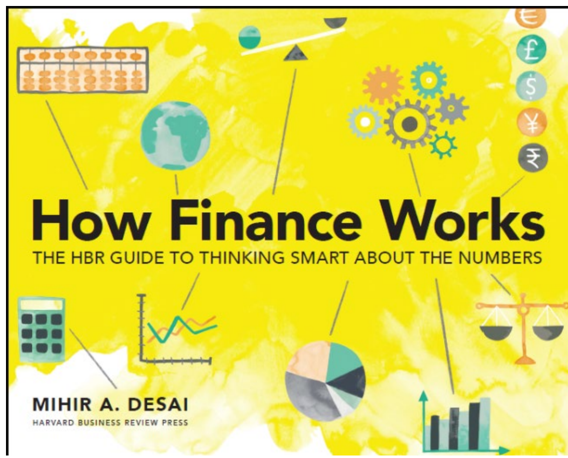

Book Title: How Finance Works: The HBR Guide to Thinking Smart about the Numbers
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You might have an unanswerable question why you should learn finance, and you might think that people who need to study and understand finance are the only those who work in finance and banking industry. If you think so, this is a perfect time you should reconsider your perspective. Whether you become aware of it or not, financial activities, events and transactions involving with the movement of cash inflows and outflows such as purchasing and selling assets or selling bonds and stocks, are around you, and it is very likely that you use finance every day. Consequently, nowadays, learning finance should be considered as one of the basic requirements of modern knowledge that will have a huge impact on your life.

In this book, the author, Mihir A. Desai, who is a professor at Harvard Business School, tried to explain you some key fundamental concepts of finance through interesting real-life case studies, color illustrations, and exercises with multiple choice questions and answers from chapter 1: Financial Analysis, chapter 2: The Finance Perspective, chapter 3: The Financial Ecosystem, chapter 4: Sources of Value Creation, chapter 5: The Arts and Sciences of Valuation, and chapter 6: Capital Allocation, respectively. Specifically, in chapter 1, you will learn about financial analysis which focuses on some of the accounting technical terms, e.g., assets, liabilities and shareholders' equity, financial statements, e.g., balance sheet and income statement, and financial ratios, e.g., liquidity ratio, profitability ratio, efficiency ratio and leverage ratio including Dupont framework. At the end of this chapter, you will learn about the benefits and limitations of the numbers and financial ratios presented in any financial statements that should make you ponder more carefully whenever you analyze financial information.

In chapter 2, the author pointed out some weaknesses of the accounting information especially the net profit. Due to accrual basis and conservatism concept in accounting, net profit completely differs from cash and cash equivalents. Thus, when you want to assess the liquidity level and liquidity risk of any company, you cannot look at the company's net profit, but instead you must look for the item called cash and cash equivalents in the balance sheet and analyze the movement of cash and cash equivalents in the statement of cash flows. In addition, you should calculate working capital, cash cycle and free cash flow, or at least, you had better use earnings before interest and tax (EBIT) or earnings before interest, tax, depreciation, and amortization (EBITDA) for your decision making. Finally, for the first time in this book, the author also introduced you to the concept of time value of money and discounted cash flows (DCF) analysis which is one of the most effective valuation methods famously used to estimate the value of any investment based on its expected future free cash flows (FCF).

Next, the author moved to the knowledge about financial ecosystem in chapter 3. Normally, the financial ecosystem involves "the entire range of market players in the financial system that have a role in efficient and sound capital allocation to sustainable, value adding projects, by matching savers and investors" (IGI Global, 2022). Thus, you will learn how the real-life capital markets is, and what the main market players such as companies, analysts, institutional investors, investment banks and broker-dealers, the medias, and households or savers do. After that, you will be introduced to the problem of asymmetric information, agency problem, and conflict of interests that will lead to one of the author's conclusions that finance is normally not about money and cash, but its main point is on information and incentives among the market players.

In chapter 4, you will learn how to create the firm's value. Generally, the firm's value is created when the firm's expected return on equity (ROE) has been more than its cost of capital for a long period of time (or at least, long enough). Besides, due to the fact that the higher the reinvestment rate, the better the rate of return, to create value, the firm's reinvestment rate must be high (or at least, high enough). Next, you will learn about the weighted average cost of capital (WACC), the differences between cost of debt (r_D) and cost of equity (r_E), the optimal capital structure, how to calculate r_D and r_E by using capital asset pricing model (CAPM), as well as the three common mistakes with WACC that you should concern.

Next, the basic concepts of many valuation methods are presented in chapter 5. In sum, the author showed you the four valuation methods which are (1) Payback Period, (2) Internal Rate of Return (IRR), (3) Multiples and (4) Discounted Cash Flows (DCF) which is considered as the most effective and the most famous method among these four. Apart from presenting you the formulas and how to analyze the calculated values in each method, the author also let you know the pros and cons of each one. At the end, the three ordinary valuation mistakes such as ignoring incentives, exaggerating synergies and underestimating capital intensity are indicated to forewarn you.

Finally, in chapter 6, after acquiring enough free cash flows, it is time for management to make difficult decisions regarding how to allocate firm's capital effectively and effectively. From the capital allocation decision-making chart summary presented in the book, management can choose to retain free cash flows and decides to either have an organic expansion or involve with merger & acquisition. On the other hand, management can choose to distribute firm's free cash flows through dividend payment or a share buyback program. However, no matter what alternatives the management choose, the most important criterion is that the chosen alternative must create (not destroy) firm's value, and always have positive net present value (NPV).

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Overall, in my opinion, although the author tried very hard to explain the basic key concepts of finance concisely through some real-life case studies and color illustrations, this book is still a bit too tough for beginners who have never taken any finance course and are not familiar with any accounting or financial terms at all. However, it should be perfect for those who have already had some fundamental financial knowledge in the past and want to brush up on it. As an accounting instructor, although I might not feel good when the author (kind of) blame accounting regarding conservatism and accrual basis, but with some basic financial knowledge, I confess that I do have fun when reading this book. Although, it is a challenging book for someone without accounting and financial backgrounds, I would like to recommend this book to everyone. It will enable you to understand the financial concepts through comprehensive and practical approaches.

However, because this book has Thai version, and I had a chance to read it, I want to raise some interesting points that might cause critical confusions for Thais. First, all real-life case studies in this book are from US companies. Therefore, there are some companies that you might have never heard of, and it is surely hard to understand the nature of those companies clearly. Second, the author used the word "Balance Sheet" for the statement that shows financial position of the company. Nevertheless, in Thailand, in accordance with Thai Accounting Standards (TAS) 1: Presentation of Financial Statements, we call the statement that presents assets, liabilities and shareholders' equity as "The Statement of Financial Position". Thus, if you read any financial statements of Thai companies, you absolutely will not see the balance sheet, and that might make any beginner very confused. Third, some translated words are not correct; for example, according to TAS 16: Property, Plant and Equipment, the term "Property, Plant and Equipment" should be translated to "ที่ดิน อาคาร และอุปกรณ์", not "ที่ดิน โรงงาน และอุปกรณ์". Furthermore, according to TAS 38: Intangible Assets, the term "Intangible assets" should be translated to "สินทรัพย์ไม่มีตัวตน", not "สินทรัพย์ที่จับต้องไม่ได้". I think these errors in translation might also trigger some confusions to persons who are new to or inexperienced in the accounting and finance field.

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