FINANCE FOR BOARDS OF DIRECTORS[1]

Business endeavours that fail for financial reasons almost always come undone because their boards of directors fail to seriously deal with these matters. A board of directors must try to avoid important risks that may jeopardise the continuity of the company, and this requires it to deal with specific tasks related with managing financial resources. These tasks or duties are extremely delicate: errors tend to have fatal consequences, leaving no room for a second chance. It is best to learn from the experience of others because by the time we learn from our own mistakes it may already be too late.

This technical paper describes the tasks that boards of directors must address when managing corporate financial resources. The first section reviews the contents of corporate finance, highlighting the differences between finance theory as taught in business schools and the elements and techniques of corporate finance actually used by directors. Neither of these two types of finance is very relevant for boards of directors, which, like managers, must develop their own models in line with the reality of their companies.

The paper proposes four tasks that boards must undertake in order to avoid serious financial problems. For ease of presentation, the paper has been written using the example of a company in which management and the board are separate. This is often not the case, especially in family businesses in which the owners and managers are the same. However, in such cases the board must ensure that these tasks are assigned to specific managers who are answerable for their fulfilment, even though the chosen institutional structure of the business is different to that of larger companies.

The conclusions present a number of recommendations for putting these tasks into practice, although this will only be possible if the institutional set-up of the company permits this. Some companies are structured in such a way that their boards are never be able to perform these tasks, thus potentially jeopardising the company's continuity.

---

[1] Technical Paper published by the Research Division of Instituto Internacional San Telmo, Spain. Prepared by Professor Juan Palacios Raufast of IESE and Instituto Internacional San Telmo for use in the classroom and not as an example of the correct or incorrect management of a specific situation. Revised in July 2012.

Copyright © May 2004, Instituto Internacional San Telmo. Spain.

The reproduction of all or part of this document, or its archiving and/or transmission in any form or by any means, whether electronic, mechanical, photocopying, recording or otherwise, without express written authorisation from Instituto Internacional San Telmo is prohibited.

CORPORATE FINANCE

Before examining the contents of corporate finance, it is first worthwhile distinguishing between three different approaches: 1) the approach used by teachers and academics; 2) that employed by managers; and 3) the approach used by the persons responsible for corporate governance. The first approach is the one described in textbooks on finance and taught in business schools. The approach to finance used by managers consists of the method or techniques they actually use in decision-making processes, and is different to the one described in what are now standard textbooks on this subject, a fact oft ignored by academics. And finally, there is the approach to finance that must be adopted by the bodies responsible for corporate governance, mainly the Chairman and Board of Directors; the objective and content of this approach differs from those in the previous two cases, but little information is available on this subject and very few initiatives have differentiated this approach to corporate finance from that used by managers. In fact, most boards end up accepting the financial methods and techniques recommended by their managers and adopting their criteria.

Managers apply technical and financial criteria to make decisions on operations and track the progress of the business. In contrast, the approach to finance adopted by boards of directors must be used to make important decisions that can affect the continuity of the company. These are political decisions that are strongly conditioned by the institutional set-up of each company in which strictly financial criteria play a very limited role. The differences between these three approaches are summarised below.

Corporate finance in books and business schools

Textbooks and courses on corporate finance can be classified into two groups: analytical and normative. *Analytical* texts and courses cover topics such as the analysis and interpretation of financial statements, cash flow forecasting, budget preparation and control, forms of asset financing, evaluation of investment projects and valuation fundamentals. This approach was very common until it began to be replaced by a normative model in the mid-sixties. Nevertheless, these types of textbooks are still published but are mainly written as introductions to corporate finance or for non-finance people.[2]

In contrast, *normative* books normally start by explaining that the main purpose of a company is to maximise the value of its investments for shareholders.[3] This goal is used as a guide to define three basic financial policies: investment policy, financing policy and dividend distribution policy. For this purpose, these textbooks present an abstract and elegant model

[2] This is the case of a book recently published by Harvard Business School entitled “Finance for Managers” (see “Bibliography” for details). A Spanish book that would fit into this category is the one by Fernández and Santomá [1995].

[3] Many books define this as the main objective of companies, above all others, while others consider that the financial objective must be made compatible with other company objectives. These types of textbooks are normally used in Masters programmes and include, for example, those by Van Horne [2001] and Weston, Besley and Brigham [1997]; and, in Spain, the textbooks by Termes [1998] and Faus [1997].

with instructions on how to proceed. For example, investments should be evaluated by calculating their expected return, after estimating their future cash flows, and then compared using a criterion such as the cost of capital for the company. As regards decisions relating to financing and dividends, the general conclusion is that both decisions are irrelevant, which is surprising because the model is based on certain assumptions that are, in most cases, unrealistic. The problem, when to try to change these assumptions, is that the model loses its prescriptive value.

For example, one of these textbooks explains the conclusions reached by the authors regarding borrowing decisions, as follows:

To summarise, the state of play regarding optimal capital structure is as follows:

1. *In an efficient, tax-free and rational market without bankruptcy costs no capital structure is optimal. Any structure is optimal, and resources are remunerated according to the risk they assume.*

2. *In a world without taxes and no bankruptcy costs, companies should borrow as much as possible (as long as the return on their investments is greater than the cost of debt before taxes) because interest is deducted before taxes.*

3. *In a world with taxes and bankruptcy costs, there probably is an optimal level of debt that will vary from company to company.*[4]

As can be seen, the financial model offers an imprecise reflection of reality. The authors mention the possible existence of an optimal level of debt but do not explain how that level is determined. From the more general perspective of company policy, it is clear that there are no optimal levels, and that this is a political decision that will be influenced by the way the company is institutionally structured. In any case, financial theory draws attention to important variables, such as the probability of bankruptcy, taxes and financing costs of the company or its shareholders. The model can therefore help people who have take decisions on relevant aspects of the problem.

There are also practical problems with the normative model in relation to investment decisions, due to the difficulty inherent in determining the expected rate of return of projects. Merton Miller, professor of finance at the University of Chicago, described the teasing he had to endure at the Nobel award ceremony in Stockholm when he had to acknowledge before the physicists and chemists present at the ceremony that the basic variable of finance - expected rate return – was not actually observable. He tried to tease back by reminding them of the neutrino, a particle with no mass whose presence was

[4] Fernández and Santomá [1995], 301.