Linking Governance to Strategy

The Role of the Finance Organization

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The capabilities, skills, and responsibilities required of finance professionals have changed significantly over the last decade. No longer limited to tracking financial results and rigorous financial reporting, finance experts are increasingly required to support strategic decision making, operation efficiency, and value creation and to combine solid accounting skills with knowledge of the business, leadership abilities, and management expertise. And such capabilities still aren't enough.

In 2002, the Sarbanes-Oxley Act (SOX) in the U.S. directly impacted the finance organization (and the CFO) by introducing new responsibilities for the trustworthiness and reliability of financial reports (Section 302) and new requirements for internal controls (Section 404). Such emerging issues and new responsibilities call for a redefinition of the role of the finance organization in the governance process. Using the case of GE Oil & Gas, we suggest that finance professionals can be much more directly involved within the corporate governance framework by playing an active role in translating governance principles into strategic decision making and strategic performance management systems. Although we include examples from GE Oil & Gas to build our argument, many of the issues we discuss are relevant and applicable for the entire GE organization.

LINKING GOVERNANCE TO STRATEGY

Despite the recent proliferation of laws, regulations, and codes of corporate governance, high-profile incidents of corporate failure and managerial misconduct have emphasized that compliance isn't enough for effective governance. Corporate governance should take into account the need to implement effective business policies and long-term objectives that represent the scope of good governance and that should provide the structure through which the company sets objectives, the strategy for attaining those objectives, and the guidelines for monitoring performance. Similarly, boards of directors should be more involved in strategy formulation rather than limiting their role to strategy ratification and monitoring management behavior. From this point of view, corporate governance can influence organizational performance insofar as it influences the strategic management of the organization.

The need for a strategic perspective in corporate governance has also been addressed by several professional accounting bodies. In a 2004 document titled *Enterprise Governance: Getting the Balance Right*, published by the Chartered Institute of Management Accountants (CIMA) and the International Federation of Accountants (IFAC) and prepared by IFAC's Professional Accountants in Business Committee (PAIB), enterprise governance is defined as "the set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately, and verifying that the organization's resources are used responsibly." Within the document, conformance to governance rules is described as only one element of overall enterprise governance. Another element is represented by performance based on strategy and value creation. In this context, the focus of the performance dimension is on helping the board make strategic decisions, understand its appetite for risk and its key drivers of performance, and identify its key points of decision making. These two dimensions of governance are deeply related to each other, and both need to be considered when designing an enterprise governance framework.

Similarly, a former president of the Institute of Chartered Accountants of England and Wales (ICAEW) emphasized that governance should be regarded not only in terms of shareholder protection but also as it pertains to business performance. The Institute of Management Accountants (IMA®) is leveraging its thought leadership in SOX and enterprise risk management (ERM) by launching a Finance GRC (Governance, Risk, and Compliance) Research Practice, which will further tighten the link between strategy and compliance via research studies and specialized certificates programs.

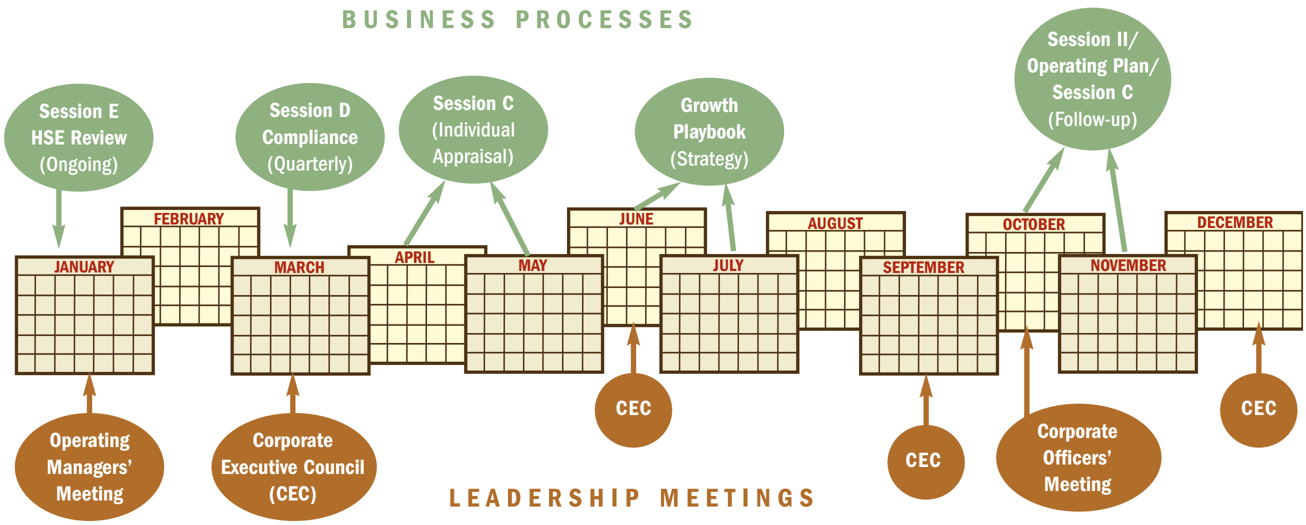
Moreover, in an August 2005 *Strategic Finance* article, "Beyond Compliance: Why Integrated Governance Matters Today," the authors highlight the need for an integrated governance framework that combines: (1) compliance with internal and external rules, codes, and principles to regulate the relations among the shareholders, board of directors, top management, and stakeholders; (2) measurement-based governance, which aligns processes and activities to organizational strategies to maximize organizational performance and value creation by using forecasts, analysis, and performance measures; (3) knowledge-based governance, which relies upon knowledge management and learning processes to align individual values, beliefs, and behaviors to the organizational mission, principles, and strategies. In addition, in their May 2007 *Strategic Finance* article, "Strategic Risk Management: Creating and Protecting Value," Mark Beasley and Mark Frigo present a case for strategic risk management that focuses on the upside as well as the downside of risk.

Despite the increasing recognition of the need for a stronger link between governance structure and strategy definition and implementation, there is still a lack of understanding of the mechanisms through which governance systems can be translated into strategy. This lack suggests exploring if and how finance professionals can play a role in providing top managers and executives with key information to foster the links between the corporate governance framework and the strategic direction of the company. Because finance professionals have been assigned crucial responsibilities by SOX and other recent national laws or codes of practices (such as the Italian Law n. 262 of December 2005 that, among other issues, introduces new roles and responsibilities of the CFO and the finance organization), they are required to broaden their understanding of the business by working alongside other managers (sourcing, production, sales, quality, IT, etc.) to design and execute new governance mechanisms. This could be both a spur and an opportunity for the finance organization to become more directly involved, alongside other managers, in the governance process. Let's look at the case of GE Oil & Gas, which offers evidence of the role of finance professionals in linking governance to strategy.

GE OIL & GAS

With more than 316,000 employees, a variety of businesses (ranging from aircraft engines and power generation to

Figure 1: GE Operating System



financial services, medical imaging, and television programming), and operations in more than 130 countries, GE represents one of the best examples of a multinational that has grown worldwide via acquisitions. Like other companies, GE relies on key operational mechanisms to provide directors, top managers, and shareholders with useful information to identify, execute, and monitor corporate strategies and the risks that these strategies present. Here we'll focus on the links among governance principles, strategic decision making, and operational mechanisms and on the role played by finance professionals within the Oil & Gas business of GE. With its headquarters located in Italy, GE Oil & Gas is a group of eight companies specializing in the supply of products and services for the oil and gas industry and offering integrated solutions for applications in all segments of the industry from wellhead to consumer. GE Oil & Gas products include gas and steam turbines; centrifugal and reciprocating compressors; subsea compressors; turbo and hot gas expanders; valves, pumps, and fuel distribution equipment; and plant design, installation, and after-market services and solutions that cover all aspects of pipeline integrity.

The Controllership Initiative

Controllership is the core initiative that has helped GE top management during the last 10 years to establish a business culture devoted to achieving high levels of performance with integrity. The principles and the requirements of Controllership are listed in GE's integrity policies booklet, *The Spirit & the Letter of Our Commitment*. Available in 27 languages, this booklet is delivered to every single GE employee. Similarly, GE holds consultants, agents, and independent contractors to the same integrity standards.

The Controllership Initiative plays a key role in implementing corporate governance in GE and in clarifying and communicating GE's policies and principles, which apply to business operations at every level of the organization. Aiming to ensure greater transparency and accuracy in financial management, as well as to enforce senior management accountability, Controllership goes "beyond the creation of an environment of corporate responsibility and seeks to foster a business culture which is nowadays fully engrained within GE operating systems," the former CFO of GE Oil & Gas says. Accordingly, the key outputs of the Controllership Initiative should be:

1. Compliance with applicable laws, regulations, and company policies;

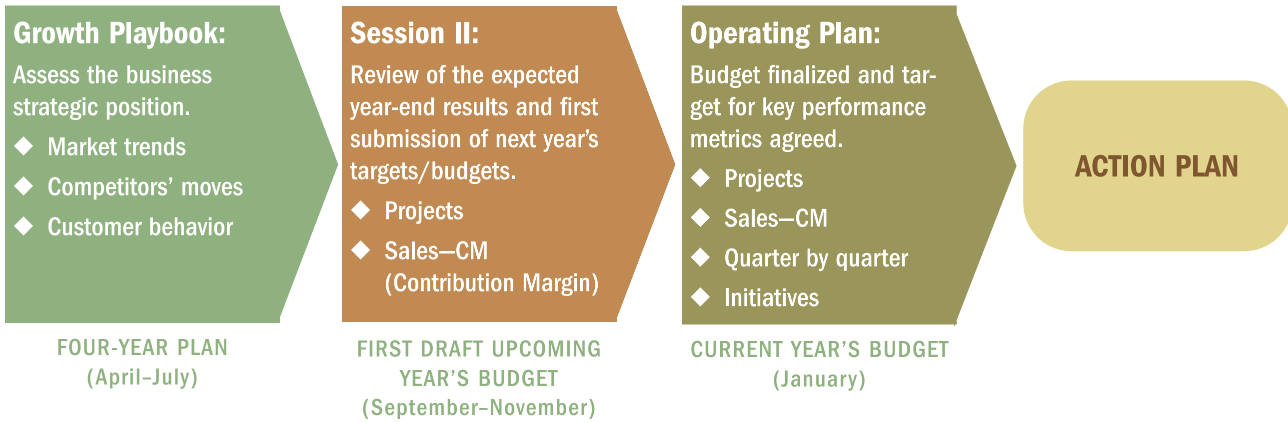
2. Integrity in communications, which shall ensure timely, complete, fair, understandable, and accurate reporting of actual and forecasted financial and nonfinancial information within all GE reports;

3. Rigorous processes in terms of performance measurement, communication, and knowledge sharing to ensure that management decisions are based on accurate economic analyses that include a prudent consideration of risks and that sound control procedures are constantly maintained.

Linking Controllership with Strategy and Budgeting: the GE Operating System

"Operationalizing controllership is not an easy task," sug-

Figure 2: Growth Playbook, Session II, Operating Plan



gests the former CFO of GE Oil & Gas, who indicates that "for each business, important issues such as the competitive environment, the customer's portfolio, as well as cost/benefit analyses are concerns that must be carefully interpreted and monitored." Therefore, even if proper recording and reporting of financial information are the foundation of compliance and integrity within GE, Controllership requires a broadened framework that relies on the ability of Finance and Operations to collaborate in understanding the risks involved in the business as well as the potential opportunities that may arise. In this context, the linkages between Controllership and the GE Operating System become crucial.

The GE Operating System entails leadership meetings and business processes (see Figure 1). During leadership meetings, corporate executives, business CEOs and CFOs, and senior managers responsible for major corporate initiatives share views and best practices from across the company. These meetings include operating managers' meetings, Corporate Executive Councils, and corporate officers' meetings. In parallel, the GE Operating System relies on an intense sequence of business processes labelled Growth Playbook (GPB, a strategy review formerly known as "Session I"), Session II (budgeting), Operating Plan, Session C (individual appraisal), Session D (compliance), and Session E (where health, safety, and environmental issues are discussed). As emphasized by the former CFO of GE Oil & Gas, "This pattern of ongoing processes and meetings sets the communication rhythm of the company, and it lies at the very heart of our mechanisms of governance."

The GE annual business planning process is broken down into three phases: Growth Playbook (GPB), Session II, and the Operating Plan (see Figure 2). The GPB starts at the GE corporate level with meetings between executives and senior teams from the various businesses. The discussion is led by the GE business leaders and challenged by corporate officers. The GPB "takes place between April and July, and it is our strategic roadmap to drive business planning and decision making," the former CFO of GE Oil & Gas indicates, clarifying that "It involves the assessment of the business' strategic position by reviewing the year-to-date results with an emphasis on the three years ahead.…It is focused on competitors' activities, new product development, and major investments, as well as on identifying the key priorities and initiatives for the coming year."

Within GE Oil & Gas, each function has a team that contributes to the definition of GPB supporting evidence and documents, such as accurate analysis concerning market trends, competitors' moves, and customer behavior (see Figure 2). In particular, GPB relies on past trends of key performance indicators such as orders, revenues, and contribution margin. As emphasized by a GE Oil & Gas senior finance manager, "The GPB is all about understanding and interpreting the market and its key trends in terms of existing and potential customers, as well as risks and opportunities of specific business decisions, so that strategies can be sketched along with their consequences in terms of expected financial returns and resource consumption over the next three to four years."

The GE Oil & Gas business planning process continues from August until November with Session II, where the foundation of the following year's budget is drafted in terms of project targets as well as sales and contribution margin estimates. "Session II is a preliminary budget where the actual orders are converted into sales and used as a basis to understand the level of the contribution margin to be expected during the next year...therefore, compared to earlier analyses grounded on historical trends, Session II relies on more accurate data in terms of lead time [cycle of conversion of orders to revenue] and offers a better ground to commit with the markets," the senior finance manager explains. The final step is the GE Oil & Gas Operating Plan, which comprises a quarter-by-quarter revision of Session II and leads to an approved budget for the new year.

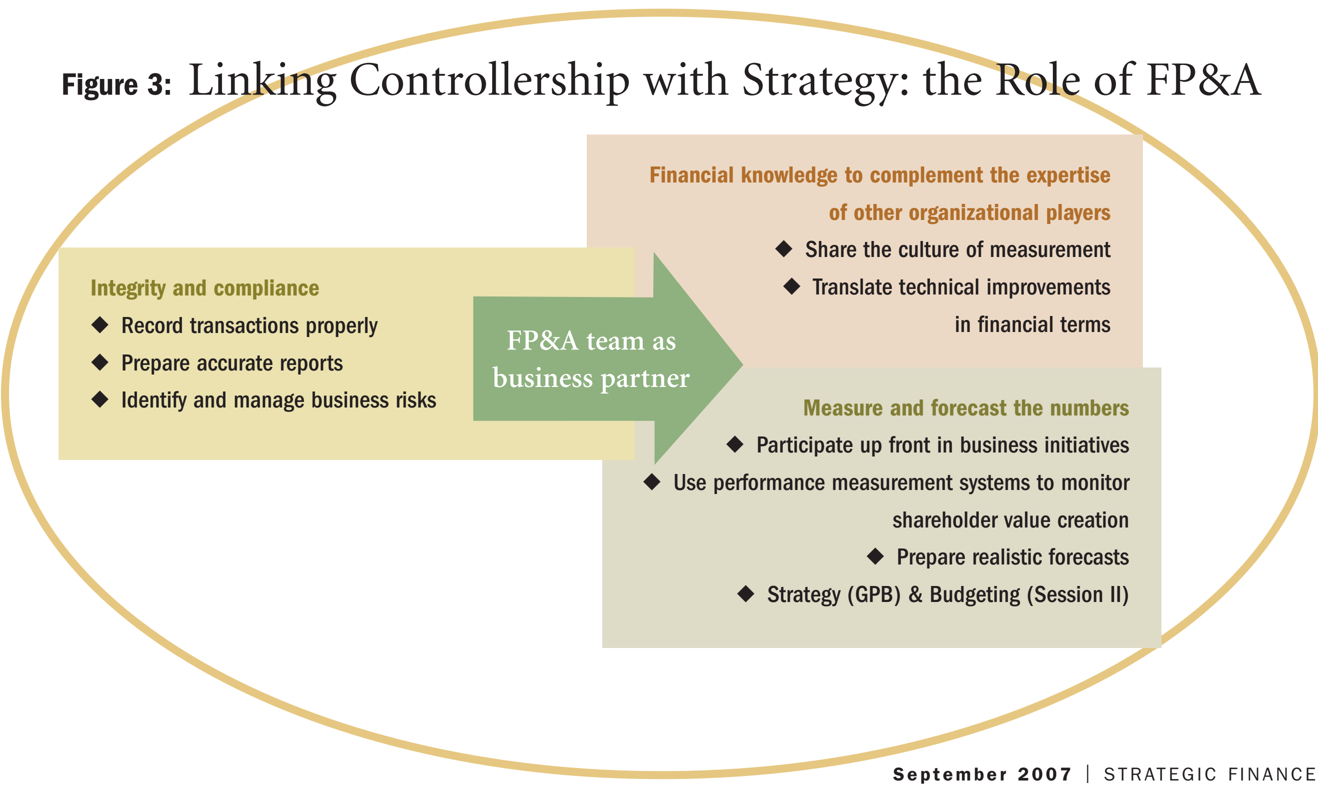
THE ROLE OF FINANCE PROFESSIONALS

The finance organization plays a major role in operationalizing the Controllership framework within GE Oil & Gas. Here we focus on the contribution offered by a section called Financial Planning and Analysis (FP&A) and by a task force of divisional finance managers. The GE Oil & Gas finance organization is built around a series of sections. Beyond FP&A and divisional finance managers, additional sections such as Manufacturing Finance—the department traditionally responsible for cost accounting—and Commercial Finance—the section that actively participates in the inquiry-to-order phase of the business—play an important role in executing Controllership in day-to-day operations.

"Within GE, FP&A means planning, communication, and compliance," the GE Oil & Gas FP&A manager explains. FP&A provides the CFO and the CEO with accurate information to make proper decisions. These financial professionals plan, monitor, and evaluate contribution margin, operating margin, cash flow, and all other key financial measures. They estimate major short- and long-term financing outlays, analyze projects to determine cost/benefit based on economic return and strategic considerations, and generate reports that provide a picture of the company's current business standing and how it defines future business risks and opportunities. They monitor the external environment by applying financial tools and techniques to assess markets and market dynamics such as competition, barriers to entry/exit, and technology. Significantly, through measurement and planning, the FP&A team is instrumental in ensuring the integrity of the financial statements that are essential for Controllership purposes. In particular, the FP&A team relies on metrics such as contribution margin, operating margin, cash flow, and all key financial measures to provide CFOs, CEOs, and the board of directors with accurate information in terms of business risks and opportunities to make proper strategic and operating decisions (GPB and Session II) as well as monitor the execution of current strategies.

Moreover, the FP&A team is responsible for business segment analyses and closing—i.e., for all financial reporting and analysis requirements (profit & loss, balance sheet), including monthly pre-close, quarterly clos-

Figure 3: Linking Controllership with Strategy: the Role of FP&A



ing, and global segment rollups, as well as the linkages with corporate processes such as the strategy definition and the Operating Plan. Finally, FP&A plays a central role in terms of communication and integration, acting as liaison among finance, front-end businesses, and headquarters. In doing this, FP&A helps to spread a degree of "financial awareness," which is perceived as crucial for GE purposes to keep performing with integrity. "We are the channel where all the key financial information flows. We touch almost everything that has to do with financial data. Being the pulse of what/how the business is doing, we have to be accurate in order to be trusted," the FP&A manager says. As summarized in Figure 3, such a pivotal position has put FP&A at the forefront of GE mechanisms of Governance and Controllership: FP&A represents an important partner for helping the different businesses to achieve and monitor their performance with integrity as well as to sketch new strategies.

Alongside FP&A, divisional finance managers supervise budgeting and reporting within the individual divisions, functions, or businesses. They coordinate business opportunities, plans, and performance measurements, as well as ensure consistency, statutory compliance, and observance of common policies and processes up to the contribution margin level. Being responsible for business financial forecasting and variance analysis, finance managers need to be constantly in touch with operation managers; for this reason, they have offices located within the premises of the specific business they work with. Reporting directly to the CFO of GE Oil & Gas, they assist operation managers with cost analysis and control and provide strong support to the businesses in following up year-to-date figures, committed expenses, and estimates. On one hand, they liaise with FP&A on financial closing processes, ad hoc analysis, and project reporting; on the other hand, they work closely with the general manager to meet the financial and operating goals of the business. Basically, finance managers represent a decentralized, front-line "access point" to the finance organization.

MAKING GOVERNANCE REAL

The case of GE Oil & Gas offers an interesting snapshot of the processes through which governance is linked to strategic decision making and strategy implementation. While governance principles and practices originate from the top of the organization, linking governance to strategy requires those principles to be diffused across the organization and to be enacted through day-to-day operations.

The Controllership Initiative provides the framework for spreading governance principles within GE operating systems and business processes. As governance is put into operation within GE Oil & Gas (see Figure 3), issues of integrity and adherence to rules, principles, and values (such as record transactions properly, prepare accurate reports, and identify and manage business risks) become integrated with the processes for measuring and managing business performance and corporate strategies (such as cost analysis and reporting, budgeting, business planning and forecasts, and strategy reviews). Such integration takes place through a shared language of measurement that fosters communication and information exchange throughout the organizational structure.

The finance organization can play a pivotal role as an access point to a shared language of measurement that draws on accurate financial accounting and reporting to collect, elaborate, and communicate the relevant performance of the business, as well as to ensure that business operations are aligned with the vision of the board; the finance organization is central in terms of communication and knowledge sharing. By being a liaison between front-end businesses and headquarters, finance professionals participate in spreading the financial awareness that is critical for GE Oil & Gas to perform with integrity. ■

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