

# BEYOND COMPLIANCE: WHY INTEGRATED GOVERNANCE MATTERS TODAY

Busco, Cristiano;Frigo, Mark L;Giovannoni, Elena;Riccaboni, Angelo;Scapens, Robert W  
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# BEYOND WHY INTEGRATED GOVERNANCE MATTERS TODAY COMPLIANCE

THE IDEA IS FOR FINANCIAL PROFESSIONALS TO  
HELP THEIR COMPANIES ADDRESS PERFORMANCE  
AND KNOWLEDGE MANAGEMENT, TOO.

BY CRISTIANO BUSCO, MARK L. FRIGO,  
ELENA GIOVANNONI, ANGELO  
RICCABONI, AND ROBERT W. SCAPENS

**S**ay the word governance, and compliance comes to mind. Performance measurement and knowledge management probably didn't cross your radar screen. They should have. Despite the proliferation of national and international codes, guidelines, and statements of best practices on corporate governance, recent company failures have shown that the primary focus on compliance isn't enough for good governance. To help your company fulfill its responsibility in terms of governance and accountability, we recommend a management tool—the Integrated Governance Scorecard (IGS)—that includes compliance but moves beyond it to address performance and knowl-

edge management. We'll provide some reasons why you should pay attention to these dimensions.

Of course, governance is a complex issue in any organization. But global companies face the steepest challenges because of the many laws, regulations, performance expectations, and cultural values. That's why all companies can learn from the best practices of leading global companies. To explore the accounting and finance practices related to governance at three international companies—General Electric, Whirlpool, and Nestlé—we conducted research from 2002 to 2004, discussing the issues with finance executives and others to ultimately create case studies.

Three research teams—from the Manchester Business School in the United Kingdom, the University of Siena in Italy, and DePaul University Kellstadt Graduate School of Business in Chicago—conducted the project. The resulting case studies are part of a research project funded by the Institute of Chartered Accountants of England and Wales (ICAEW).

## REPORTS, CODES, AND LAWS

The governance debate has been a hot topic among business executives, financial professionals, and academics. Following recent corporate failures and allegations of management misconduct, the mechanisms through which companies are directed and controlled have been put under scrutiny. In an attempt to regulate key organizational issues, several reports, codes, and laws have appeared worldwide, focusing on the legal and regulatory framework for managing and supervising a company. Let's take a look at the pivotal ones.

The Cadbury Report, published by the Cadbury Committee in 1992 and set up by the Financial Reporting Council of the London Stock Exchange, represented a milestone in setting out measures to enhance corporate integrity based on improved information, continued self-regulation, more independent boards, and greater auditor independence. Although the Cadbury Report broadly defines corporate governance as the system by which companies are directed and controlled, it focuses only on the financial aspects of accountability.

Several recent codes and best practices on corporate governance have attempted to identify the actual mechanisms for ensuring good governance and control. They pay close attention to senior executive compensation systems, internal auditing, and financial reporting. The 1992 report from the Committee of Sponsoring Organizations of the Treadway Commission (COSO), titled

*Internal Control—Integrated Framework*, represented a milestone in providing guidelines and best practices on internal control. The report defined internal control as a process affected by an entity's board of directors, management, and other personnel that's designed to provide reasonable assurance to achieve objectives in the following categories:

- ◆ Effectiveness and efficiency of operations;
- ◆ Reliability of financial reporting; and
- ◆ Compliance with applicable laws and regulations.

The Turnbull Report was another milestone. At the request of the London Stock Exchange, the Institute of Chartered Accountants of England and Wales prepared the Turnbull Report in 1999. It provided guidelines to the board of directors on risk management and internal control, including financial, operational, technological, reputational, and environmental risks. Three years later, the Sarbanes-Oxley Act of 2002 (SOX) and the Securities & Exchange Commission (SEC) rules imposed specific requirements on listed companies that would increase transparency and establish new standards for corporate accountability as well as penalties for managerial misconduct. Certainly a lot more for the finance organization to get its hands around!

## THE THREE SIDES OF ACCOUNTABILITY

To survive and thrive, you can't think of accountability only in terms of compliance with a set of principles according to which managers are required to behave in order to fulfill stakeholder expectations. All employees need to be accountable today. So you need to ingrain management accountability into employees' day-to-day way of thinking and behaving within the organization and in the set of values, beliefs, and attitudes that shape organizational activities and interactions. That's where knowledge management and organizational culture come in to promote individual commitment to company goals and values.

You should view accountability toward your stakeholders in three perspectives—compliance, performance, and knowledge (see Figure 1):

**Compliance.** To ensure effective accountability to stakeholders, you have to achieve organizational performance and value creation in accordance with internal and external rules, codes, and principles. Lacking compliance can damage your company's image and reputation, thereby affecting organizational performance.

**Performance.** Since your company is accountable to the shareholders for organizational performance and val-

ue creation, you need to recognize the risks—financial, operational, reputational, environmental, etc. Managers are accountable for effective risk management, which is crucial for ensuring organizational performance and shareholder value creation. This requires compliance with risk standards as well as a cultural awareness of the risks involved in everyday activities.

**Knowledge.** Company principles, rules, goals, and strategies affect—and are affected by—organizational culture. In particular, knowledge management and learning processes can enhance an employee’s commitment to the rules, principles, and goals, ultimately promoting managerial compliance and organizational performance. They also shape and are shaped by risk management practices.

You can address the three sides of accountability through different dimensions of governance—corporate governance, measurement-based governance, and knowledge-based governance:

1. Corporate governance ensures compliance with internal and external rules, codes, and principles. It regulates the relations among the shareholders, board of directors, top management, and stakeholders.
2. Measurement-based governance 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 manages processes of learning and knowledge sharing. It relies upon knowledge management, learning processes, organizational culture, and values. It aligns individual values, beliefs, and behaviors to the organizational mission, principles, and strategies through knowledge sharing and learning processes.

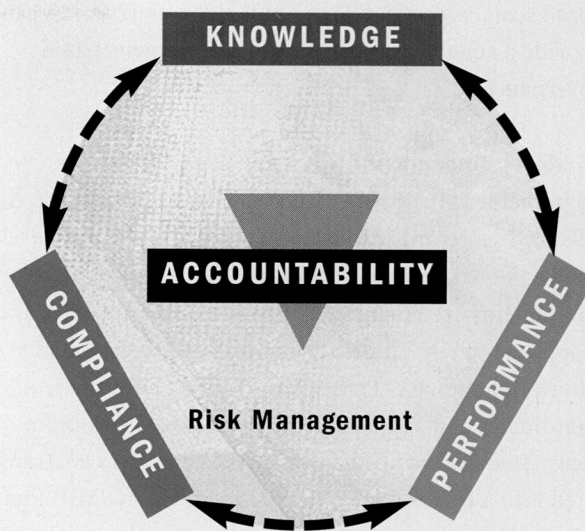
Both corporate governance and measurement-based governance influence and are influenced by knowledge-based governance. They require effective risk management to improve organizational performance while ensuring compliance with risk standards.

## IMPLEMENTING THE THREE DIMENSIONS OF GOVERNANCE

### Corporate Governance

In this proliferation of best practices and guidelines on the mechanisms for implementing good corporate governance, primary emphasis has been on internal auditing and financial accounting. The 2004 COSO report on enterprise risk management, however, emphasized other organizational mechanisms, such as extending and integrating the internal control framework from the 1992 COSO report. Our General Electric case research shows

**Figure 1: The Three Sides of Accountability**



that specific initiatives can play a key role alongside internal control systems in implementing corporate governance. The “controllership initiative” at GE, the main principles in the GE booklet “The Spirit & Letter,” aims to clarify and to communicate GE corporate governance principles, which are linked to business operations at every level.

The need for combining statutory compliance (i.e., statutory measures to encourage compliance provided by national codes and regulations) with voluntary compliance (i.e., voluntary codes and initiatives) is also emphasized by the 2000 report, “Corporate Governance—History, Practice and Future,” from the Chartered Institute of Management Accountants (CIMA) in London. This report builds on the 1992 Cadbury Code and highlights “the risk that statutory measures would encourage compliance to the ‘letter, not the spirit’ of the Code.”

### Measurement-Based Governance

The performance side of accountability requires specific measurement systems for aligning performance with organizational strategies to achieve shareholder value creation. In 2004, CIMA and the International Federation of Accountants (IFAC) described the role of performance measurements in implementing the enterprise governance system. They proposed a strategic scorecard as a governance tool for measuring and monitoring the organization’s strategic position, options, and risks. Similarly, other professional bodies proposed different sets of key performance indicators (KPIs) and scorecards for corporate leaders to use to monitor the governance system. For example, PricewaterhouseCoopers built a framework in

2004 that integrates governance through risk, compliance, and performance management. And, of course, the balanced scorecard as developed by Kaplan and Norton can provide a suitable framework of measurement-based governance.

#### **Whirlpool Corporation**

To implement the performance side of accountability, the balanced scorecard works for Whirlpool. This firm developed a Global Balanced Scorecard (GBS) whose main components are Financial, Customer, and Employee, and it applies them to all the regions and countries where Whirlpool operates. Through the GBS, the company coordinates and aligns regional strategies to corporate goals. At an individual level, the GBS objectives are translated into a Performance Measurement Plan (PMP) that sets the individual employee objectives for the year in terms of performance, behavior, and personal development. Individual performances are aligned to regional and corporate goals as well as strategies through the GBS and the PMP. The performance and the knowledge sides of accountability are related to each other through the GBS and the PMP. The two tools help communicate and clarify corporate objectives, priorities, and values, as well as align individual priorities to corporate values.

#### **Nestlé Waters**

KPIs and scorecards aren't the only performance measurements you can choose for the performance side of accountability. Consider Nestlé Waters. This company uses tools such as the budget and the "End-to-End Profit and Loss Statement" (ETE P&L). In 2001, two business units of Nestlé Waters implemented the ETE P&L to measure the joint profitability of the producers of Nestlé Waters international brands and the internal distributors (i.e., those that belong to the Nestlé corporation). The new performance measurement system integrates product strategies across different countries and promotes an information exchange process and interaction among different companies belonging to the Nestlé group.

#### **General Electric**

In addition to accounting systems, corporate initiatives and projects can play a central role in implementing measurement-based governance. Since the early 1990s, GE's Six Sigma project has aimed to boost profitability by improving the quality of products and services. Six Sigma uses a rigorous business process analysis tool to reengineer ways to add value to the customer. Besides the impact on

the bottom line, the Six Sigma initiative provided GE with a shared language of financial and nonfinancial indicators that helped management build a lasting customer-focused culture rooted around performance measurements.

#### **Knowledge-Based Governance**

While the compliance and the performance sides of accountability rely mainly on formal control mechanisms (organizational charts, codes and practices, planning and budgeting system, etc.), the knowledge dimension uses both formal and informal mechanisms. Formal mechanisms include the systems for sourcing, storing, sharing, and building knowledge assets. In this context, you can see how information systems become crucial for governing knowledge.

Informal mechanisms, however, are more difficult to structure into specific tools or systems. Since informal mechanisms include learning processes, corporate culture, trust, and power relations, they're more likely to take place through lateral communication, and they both affect and are affected by the formal mechanisms. Sharing knowledge and learning from the experiences of others can help you improve organizational performance as well as promote a common culture.

#### **Nestlé Waters**

Nestlé provides an example of the role information systems play in governing knowledge. Its Global Business Excellence (GLOBE) program aims to harmonize and simplify business process architecture through an integrated information system. Launched in 2000, GLOBE provides Nestlé companies with common guidelines, structures, and best practices to integrate operations across the whole organization and to align organizational strategies with corporate goals. The idea behind a shared information system? Provide managers with a common language to improve knowledge sharing and learning processes as well as achieve coordination and integration within Nestlé.

#### **General Electric**

In addition to integrated information systems like at Nestlé, training and communication through meetings and internal publications play a key role in governing knowledge within the organization. Consider General Electric and Nuovo Pignone. After GE acquired this formerly state-owned Italian company, Nuovo Pignone underwent a deep process of culture transformation to adapt to the managerial style of a global corporation. In this context, training programs and communication skills helped change the "old" ways of thinking about



the business and provided the organization with a new culture. The cultural change infused Nuovo Pignone with the GE way—a business philosophy built on leadership, accountability, and performance measurement—so Nuovo Pignone moved from being an Italian state-owned company to a part of an American multinational corporation.

#### Whirlpool Corporation

Reporting tools, such as the balanced scorecard, can play a key role in managing knowledge and disseminating common values and principles. Whirlpool, for instance, implemented its Global Balanced Scorecard as a result of a cultural audit, which they carried out in 1996. Along with the GBS they developed a shared language of financial and nonfinancial measures supported by the Performance Measurement Plan, which translates organizational strategies into individual objectives.

#### THE INTEGRATED GOVERNANCE FRAMEWORK

We've described and illustrated the main dimensions of governance (corporate governance, measurement-based governance, and knowledge-based governance) and identified some of the ways to use them. But you can't view governance in terms of separate subsystems. Instead, you

should design and implement it as an integrated framework (see Figure 2).

Despite more and more professionals realizing the importance of integrating compliance, performance, and knowledge in governing global organizations, you still need a clear concept of the governance framework. That's where the Integrated Governance Framework comes in. It helps you define the main characteristics of accountability, which should comprise the mechanisms for ensuring:

- ◆ Compliance with company rules, principles, and external laws and regulations;
- ◆ Organizational performance and value creation; and
- ◆ Knowledge management and sharing of best practices.

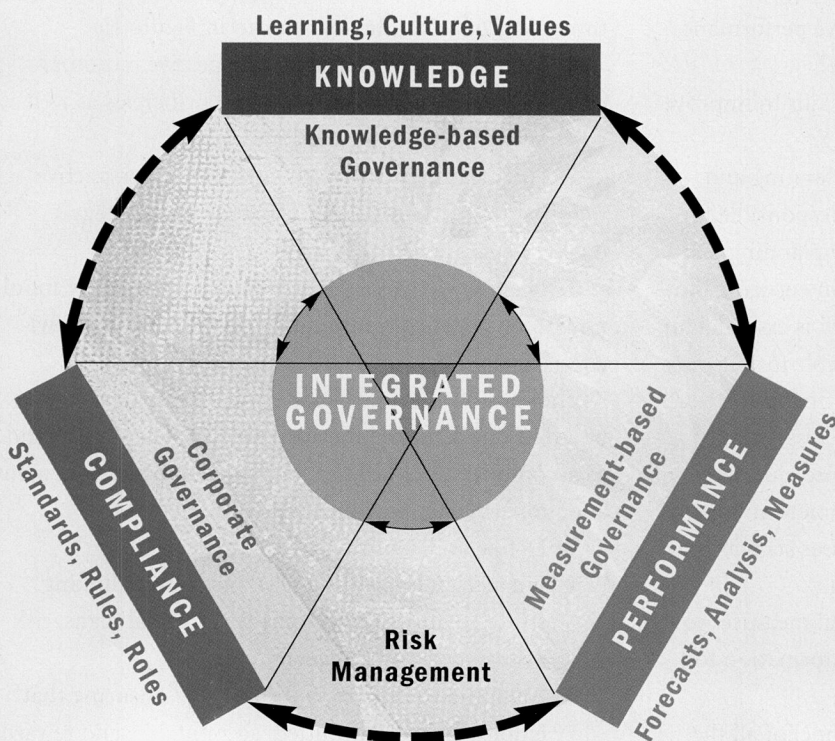
#### THE ROLE OF FINANCE

Within an integrated governance framework, the CFO and the finance organization have key roles in coordinating the various dimensions of governance. During the last 10 years, the role of financial professionals has been changing, and the finance organization increasingly has been required to work out of the box and broaden its knowledge by interacting closely with operations and project managers. This process has often involved cross-functional teams rather than number crunching in a separate accounting function, but, most

importantly, it requires an adjustment to existing thinking, expertise, and skills. Though more attention has been paid to the role finance professionals play in integrating compliance and performance measurement, less attention has been given to the finance organization's holistic contribution.

The role of the finance organization shouldn't be limited to compliance and performance. The stakes are too high. As you know, the need for a more rigorous accountability took the form of stringent new corporate accounting and reporting rules such as those in Sarbanes-Oxley and the new International Accounting Standards. These new regulations mandate better internal controls and, in the case of SOX, require CEOs and CFOs to personally certify financial results. No doubt CFOs and the finance function have become crucial

Figure 2: The Integrated Governance Framework



for the organization's image and success. They're required to collect and deliver the stories behind the numbers to a large group of sophisticated stakeholders. In fulfilling such rising expectations, the most difficult challenge for the finance organization is to build a collaborative environment that allows internal stakeholders at every level to participate in, contribute to, and take ownership of the compliance processes, the system of strategic planning and budgeting, and knowledge sharing.

#### **Key Issues and Evidence from the Field**

Reshaping governance and accountability requires the CFO and the finance organization to integrate governance processes by leading compliance, performance measurement, and knowledge management through the organization. Sarbanes-Oxley requires finance professionals to be increasingly involved in strategy deployment, performance measurement, and processes of continuous improvement. This means that implementing an integrated governance system requires the finance organization and the CFO to use a broad array of skills to support the three dimensions of governance, including:

- ◆ Controlling and monitoring skills (auditing, assurance, knowledge of internal and external rules and codes) to improve both internal and external compliance;
- ◆ Knowledge of the business to improve organizational performance;
- ◆ Experience supporting decision-making processes and teamworking abilities to improve performance and coordination; and
- ◆ Interpersonal and communication skills to improve knowledge sharing and teamworking.

Here's how GE does it. The Financial Planning and Analysis (FP&A) professionals at GE are responsible for:

**Integrity and compliance:** Through the planning and reporting activities, they're instrumental in ensuring the integrity of the financial statements, which is essential for controllership purposes. FP&A is responsible for business segments analysis and closing, i.e., for all financial reporting and analysis requirements (profit and loss, balance sheet, volume), including monthly pre-close, quarterly closing, management packages, global segment rollups, as well as the linkages with corporate processes such as the strategy definition and the operating plan.

**Decision making:** They analyze financial measures to provide CFOs and CEOs with accurate information to make proper decisions.

**Communication:** They're the main channel of all the

company's financial information, providing a liaison among finance, front-end businesses, and the GE headquarters. They plan, report, and analyze the business and its implications in terms of numbers.

According to a senior GE FP&A manager, "FP&A operationalizes planning, communication, and controllership. We investigate our financials to provide the CFO and the CEO with accurate information to make proper decisions. We plan, monitor, and evaluate contribution margin, operating margin, cash flow, and all key financial measures. We 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 current business standing and how this defines future business risks and opportunities."

FP&A has such a pivotal position it has put Finance at the forefront of the GE organization. According to the FP&A manager, "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 and reliable in order to be trusted."

#### **THE INTEGRATED GOVERNANCE SCORECARD**

The Integrated Governance Scorecard is a tool to assist corporate executives, such as CEOs and CFOs, in fulfilling their tasks and meeting their responsibility in terms of governance and accountability. The IGS reflects the three sides of accountability shown in Figure 1:

1. The corporate governance perspective monitors compliance with corporate rules and principles as well as adherence to external regulations.
2. The measurement-based governance perspective monitors organizational performance and strategy deployment.
3. The knowledge-based governance perspective monitors processes of communication, learning, and knowledge sharing.

The executive team can use the IGS to explain to the board of directors and the shareholders how they intend to accomplish their tasks in terms of strategy deployment and, in particular, how they intend to:

- ◆ Define and communicate strategy;
- ◆ Finance and operationalize the strategy, linking strategic initiatives to long-term capital plans, risk assessment, and budgetary control;
- ◆ Align the workforce to the strategy, ensuring that employees are committed, accountable, and reward-



**Table 1: The IGS (Corporate Level)**

| Integrated Governance Dimensions | Mechanisms  | Review of Progress | Impact Assessment | Areas for Development |
|----------------------------------|-------------|--------------------|-------------------|-----------------------|
| CORPORATE GOVERNANCE             | Initiatives | ...                | ...               | ...                   |
|                                  | Programs    | ...                | ...               | ...                   |
|                                  | Systems     | ...                | ...               | ...                   |
| MEASUREMENT-BASED GOVERNANCE     | Initiatives | ...                | ...               | ...                   |
|                                  | Programs    | ...                | ...               | ...                   |
|                                  | Systems     | ...                | ...               | ...                   |
| KNOWLEDGE-BASED GOVERNANCE       | Initiatives | ...                | ...               | ...                   |
|                                  | Programs    | ...                | ...               | ...                   |
|                                  | Systems     | ...                | ...               | ...                   |

ed for executing key priorities;

- ◆ Support the strategy deployment, ensuring initiatives are in place to regularly review and discuss strategic performance; and
- ◆ Provide clarity and reliability of financial and non-financial reports for internal and external purposes.

To play a central role, the CFO should team up with the CEO in executing an integrated governance strategy—and culture—by deploying the IGS across the entire organization. Don't limit your finance organization to integrity assurance and effective compliance. Finance professionals also have to identify the financial consequences of process improvements as well as build a cross-functional language to collect and share business-oriented knowledge with operating units. In particular, CFOs must organize the finance function to:

- ◆ Have finance professionals with knowledge about the business processes;
- ◆ Participate in the strategic decision-making process;
- ◆ Support front-line managers; and
- ◆ Stimulate awareness of the financial consequences of the operations.

### IGS at the Corporate Level

Executives at the corporate level are responsible for identifying and implementing plans to achieve long-term and ethical value creation in line with the company's mission, values, and strategy. For each dimension of governance, you can use the IGS to monitor specific initiatives, programs (i.e., the structured deployment of tied initiatives), and systems (i.e., the organization-wide diffusion of a

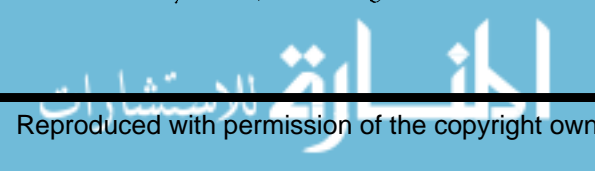
series of practices that penetrate the way the company works). You should follow the execution of initiatives, programs, and systems needs with a review of the progress and identify their potential/actual impact (impact assessment) on the three dimensions of integrated governance. Finally, you need to identify areas for development (see Table 1).

Initiatives may remain isolated experiences, or they can get embraced within more ambitious programs and organizational systems as at GE:

- ◆ Corporate governance initiatives such as controller-ship are fully integrated within organization-wide systems that aim to review compliance with all reporting guidelines and other requirements;
- ◆ Individual initiatives such as Quick Response (introduced to improve customer delivery times and reduce inventory levels) or Bullet Train (launched to cut down indirect costs) are now part of the broader measurement-based Six Sigma program; and
- ◆ Individual initiatives such as Boundaryless and Work-Out (introduced to eliminate boundaries and create open communication flow throughout the organization) are part of human resource management, where the talent and the level of commitment to strategic initiatives are evaluated within a specific program called Session-C.

### IGS at the Business-Unit Level

Executives at the corporate level are accountable for creating overall long-term value in line with the company's mission, values, and strategy, while the individual business-unit managers are responsible for managing





## Examples of Objectives and KPIs for the IGS (Business-Unit Level)

| Corporate Governance Objectives                         | KPIs  |
|---|---|
| Meeting the financial reporting agenda and book closing | <ul style="list-style-type: none"> <li>◆ Cycle time to complete returns for the annual report</li> <li>◆ Error-correction entries as a percentage of total entries</li> </ul>                           |
| Standards of internal business conduct                  | <ul style="list-style-type: none"> <li>◆ Frequency of reviews to assess individual conformance to corporate codes of conduct</li> <li>◆ Number of ethical and legal violations</li> </ul>               |
| Implementing risk assessment/management                 | <ul style="list-style-type: none"> <li>◆ Number/value of projects/processes assessed</li> <li>◆ Losses associated with underestimated risks</li> </ul>  |
| Auditing activities                                     | <ul style="list-style-type: none"> <li>◆ Number of processes audited within a financial reporting cycle</li> <li>◆ Number of invoices reviewed within revenue-recognition processes</li> </ul>          |
| Measurement-Based Governance Objectives                 | KPIs  |
| Shareholder value creation (financial)                  | <ul style="list-style-type: none"> <li>◆ Cash flow</li> <li>◆ Revenue growth</li> <li>◆ Operating margin</li> </ul>   |
| Customer satisfaction                                   | <ul style="list-style-type: none"> <li>◆ Market share</li> <li>◆ Number of customer complaints</li> <li>◆ Delivery time</li> </ul>  |
| Business process redesign                               | <ul style="list-style-type: none"> <li>◆ Order-to-cash cycle</li> <li>◆ Time to market</li> <li>◆ Material efficiency improvement</li> </ul>  |
| Meeting the management accounting agenda                | <ul style="list-style-type: none"> <li>◆ Cycle time to complete operating plan and budgets formulation</li> <li>◆ Best practices introduction rate</li> <li>◆ Accuracy of year-end forecasts</li> </ul> |
| Knowledge-Based Governance Objectives                   | KPIs  |
| Internal climate  | <ul style="list-style-type: none"> <li>◆ Personnel turnover rate</li> <li>◆ Ratio of voluntary to involuntary terminations</li> <li>◆ Employee satisfaction survey/rate</li> </ul>                      |
| Training  | <ul style="list-style-type: none"> <li>◆ Number of training courses per year</li> <li>◆ Training costs as a percentage of sales</li> </ul>  |
| Managing talent pool                                    | <ul style="list-style-type: none"> <li>◆ Number of initiatives to assess new ideas per year</li> </ul>  |
| Communication and knowledge sharing                     | <ul style="list-style-type: none"> <li>◆ Number of interdepartmental workshops/year</li> <li>◆ Number of intranet-based knowledge-sharing initiatives per year</li> </ul>                               |



**Table 2: The IGS (Business-Unit Level)**

| Integrated Governance Dimensions | Objectives | KPIs | Targets | Actuals | Steps for Improvement |
|----------------------------------|------------|------|---------|---------|-----------------------|
| CORPORATE GOVERNANCE             | CG1        | ...  | ...     | ...     | ...                   |
|                                  | CG2        | ...  | ...     | ...     | ...                   |
|                                  | CG3        | ...  | ...     | ...     | ...                   |
| MEASUREMENT-BASED GOVERNANCE     | MBG1       | ...  | ...     | ...     | ...                   |
|                                  | MBG2       | ...  | ...     | ...     | ...                   |
|                                  | MBG3       | ...  | ...     | ...     | ...                   |
| KNOWLEDGE-BASED GOVERNANCE       | KBG1       | ...  | ...     | ...     | ...                   |
|                                  | KBG2       | ...  | ...     | ...     | ...                   |
|                                  | KBG3       | ...  | ...     | ...     | ...                   |

operations on a day-to-day basis. For this reason, you need to translate the initiatives, programs, and systems into objectives and KPIs for lower levels of the organization. In Table 2 we illustrate a possible IGS for business-unit managers, which you can use to monitor the actual achievement of corporate strategy as well as identify areas for improvement. The specific objectives will come from the initiatives, programs, and systems within each dimension of governance.

Each objective describes what business-unit managers must accomplish to be successful in all three dimensions. To measure the objectives, you use specific key performance indicators that should be financial and nonfinancial, leading and lagging, internal and external. Then you discuss appropriate targets to reflect the organization's commitment to integrated governance and compare target and actual data to see whether you're achieving the strategy. And, finally, you identify steps for improvement.

You should tailor the objectives and the KPIs to the specific needs and characteristics of your company. The sidebar on the opposite page provides some examples of objectives and KPIs for each dimension of the IGS that you can use at the business-unit level.

### INTEGRATED GOVERNANCE MOVING FORWARD

Compliance, performance, and knowledge sharing require common understandings, attitudes, and beliefs. As finance professionals, if you want to be viewed as the key players in the processes of integrating governance, then actively develop and maintain a common organizational language across all operations of the business, not just in finance. The management tool IGS can make governance truly

integrated, and it provides a framework to engage everyone. It's simply a pathway for good governance. ■

*Cristiano Busco, Ph.D.; Elena Giovannoni, Ph.D.; and Angelo Riccaboni, Ph.D., work at the University of Siena, Italy. Cristiano is an associate professor of management accounting, Elena is a research fellow, and Angelo is dean of the faculty of economics and chairman of CRESCO, The Center for Evaluation and Control. You can reach Cristiano at busco@unisi.it, Elena at giovannoniel@unisi.it, and Angelo at riccaboni@unisi.it.*

*Mark L. Frigo, Ph.D., CPA, CMA, is director of The Center for Strategy, Execution and Valuation and Eichenbaum Foundation Distinguished Professor of Strategy and Leadership in the Kellstadt Graduate School of Business at DePaul University in Chicago. He is a leading expert in strategy design and execution and co-developer of the Return-Driven Strategy framework with Joel Litman. You can reach Mark at mfrigo@depaul.edu.*

*Robert W. Scapens, Ph.D., FCA, is professor of accounting in the Accounting and Finance Group, a division of the Manchester Business School. He is also a professor in the area of Management Accounting at the University of Groningen in the Netherlands. You can reach him at robert.scapens@mbs.ac.uk.*

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