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"Adding innovation to the CFO's agenda

When a group of CFOs at Deloitte's CFO Vision Conference last fall were asked whether anyone in the audience had grown tired of hearing about innovation, several people raised their hands.

Geoff Tuff
"For some CFOs, the term innovation has become meaningless and has been applied to just about anything that can justify budgets in a company," says Geoff Tuff, Deloitte Consulting LLP, who leads Doblin, the innovation practice of Monitor Deloitte. *"Moreover, according to Doblin research, 95% of innovation attempts, on average, do not return their capital,"* he adds. Little wonder some CFOs are sceptical of innovation.

"Yet CFOs are the people who can bring discipline and analytical thinking to the innovation process, which are needed for success," says Mr. Tuff. Below he and Bansi Nagji, principal of Deloitte Consulting LLP and leader of Monitor Deloitte, discuss why CFOs should play a larger role in setting and managing an organisation's innovation agenda and the value they can bring.

The two veteran thought leaders on innovation are co-authors of *Managing Your Innovation Portfolio*, published in Harvard Business Review, and have contributed to other major business publications.

Q: Many companies use the '70/20/10 rule', described in your 2012 Harvard Business Review article, to set their innovation strategy. What is the rule, and how can CFOs apply it?

Geoff Tuff

Before describing the rule, I think it is important to ask, 'What is innovation?' Innovation is creating new value, new to our market or to the world and value is defined as economic value for an organisation's customers and the organisation itself. Innovation does not have to be high cost and it certainly does not have to be high risk.

The 70/20/10 rule is a basic guideline which stipulates that, for the average organisation, 70% spent on innovation initiatives should be focused on an organisation's core business, 20% on adjacent opportunities and 10% on projects that could be transformational for the organisation and perhaps the market more broadly. The right percentages for any given company will vary depending on the industry and the organisation, including how mature it is and its strategic and risk profiles. The economic return expected of the organisation is also a critical element in setting those ratios. So innovating at the core or adjacent businesses can be much more important to some companies than others, and such businesses would minimise their focus on transformational projects.

In each of those three levels of innovation, it is the domain of the CFO to help customise a target portfolio of innovation projects, taking into consideration the company's objectives, risk appetite and cost constraints. And the finance department may be best at applying the objective data to test the range of what those innovation targets might be.

Q: Shouldn't CFOs incorporate innovation strategies into their forecasting and planning, and, if so, be more involved in strategy development?

Bansi Nagji

This is where the CFO's perspective is important to the whole innovation strategy-setting process. Most companies are not yet operating at a level where CFOs are playing a substantive role in setting an innovation agenda, but that is changing. More than 50% of the large company CFOs at the conference mentioned earlier confirmed they are being asked by their CEOs to play a key role in evaluating, financing and driving innovation in their companies. Of the remaining CFOs, 36% confirmed that their CEO expects them to support and enable the execution of innovation decisions.

If CFOs are going to incorporate innovation strategies and their expected results into forecasts at any point in time, they are also going to have to take into account the commitment they have made to shareholders already, the company's risk profile and how the innovation strategy will influence finance's objectives. At the same time, they need to exercise a less constrained perspective about certain types of innovation within their portfolio and how they can be funded, given the company's market share or growth objectives within the industry. The challenge that a lot of companies run into is balancing the need to manage risk in the short term while pursuing growth for the long term, and CFOs can play a valuable role here.

Q: Are there leading practices to measure and monitor the pipeline of innovation-driven ideas and compare their benefits to the organisation?

Geoff Tuff

As companies think about applying metrics to innovation initiatives, it is important to apply traditional external economic metrics, such as sales, revenue increase or market share change, to the right situations. Traditional metrics are generally appropriate for an innovation programme that is connected to the core business. As the innovation project gets further away from the core business, other types of metrics, typically non-economic internal metrics, should be considered. An example of an innovation metric to measure innovations far from the core business is learning—the degree to which a CFO or an executive team is willing to fund an initiative purely for the purpose of learning something. It does not matter if the initiative succeeds or fails, and it does not matter if the investment has a market impact for the company. Rather, if leadership can learn something critical from the initiative, that in itself can justify continuing to focus on the project or funding it. Once the project gets closer to launch, CFOs and others will be able to layer in more traditional measures, such as market testing and piloting.

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> *Geoff Tuff*

Q: Some companies are able to innovate in ways that customers respond to well. How do those companies get to the point of understanding their customers and then innovating around them?

Bansi Nagji

The big mind-set shift in thinking about innovation is dealing with adjacent and transformational issues. That requires delving into the world of what is currently not known. One of our suggestions for executives, particularly with transformational innovation, is not to spend a lot of time asking customers why they do or do not want a product or service. Instead they should be thinking about how customers use a product or service, how they could incorporate it into their everyday lives. And then you can start to imagine how customers could substitute one, two or sometimes three other products that currently exist in the world with a product that currently does not exist.

Q: Is there a role for the CFO in this exercise?

Geoff Tuff

What the CFO can do very well here is engage in the discussion of the business model and what constraints may exist. That also includes false constraints that can be overcome in terms of changes to the business model, such as different ways to deliver services or products to customers that currently are not being used but that are possible. It is rare to have CFOs involved in conversations about what a company can change in order to serve customers better, but CFOs need to make themselves part of this discussion even though it is not the type of meeting they are typically invited to.

Bansi Nagji
Many CFOs do not get enough exposure to the world of understanding customers. Yet, they will need to be much more facile with understanding customers and what drives their behaviour, as well as understanding non-customers and why they are not behaving in certain ways—all of which can have a financial impact. In general, when you see an executive team that includes the Chief Marketing Officer (CMO) and the CFO, you will tend to find CMOs switching off when the CFO is presenting and vice versa. However, it is an opportunity for CFOs to both learn more and weigh in.

Q: What can CFOs do to participate more in their organisations' discussions and decisions on innovation?

Geoff Tuff
If anyone in the organisation understands what drives the economics of the business, it is the CFO. The opportunity we see for CFOs is not so much playing the role of sceptic but rather the voice of reason, keeper of the data-rooted business model. A CFO can engage with the innovation teams as the person who says 'yes' on a number of occasions because he or she can logically relate innovation to the key drivers of the business and how some ideas outside of the core business may be worth pursuing. But CFOs are also needed to make sure that there are guard rails in place to protect the core business and that people do not cross them. CFOs are the ones who can ensure that the core business does not get fundamentally hurt as innovation teams start to play with different business models.

Bansi Nagji
CFOs should understand where their organisation's innovation efforts are and where they stand. Are they moving as planned and meeting milestones or have they stalled? Many companies would not be able to answer these questions and it is the job of the CFO to know the answer.

CFOs can also help align portfolio choices with agreed-upon innovation initiatives and ensure the portfolio is appropriately resourced so that requests for more funding do not come in at the last second. Using their analytical skills and tools, they can create a smart metric system and valuation methodology that reflects the mix of the innovation ambitions, and they can help keep their organisations focused on fewer, bolder initiatives versus a larger number of disjointed innovation projects.

In my opinion, CFOs should become a strategic partner to other functions and get out of the business of being the person who says no, leaving innovation to R&D, strategy and operations. When they participate in innovation, they have the opportunity to instil discipline while serving as a catalyst for change. Innovation is fundamental to the strategic direction of a company, and it is logical that the CFO should play a larger role in the process.

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Related Resources
- *Managing Your Innovation Portfolio, Harvard Business Review, May 2012*
- *CFOs to Play a Larger Role in Their Organizations' Innovation Process*
- *Ten Types of Innovation: The Discipline of Building Breakthroughs*
- *Realigning Your Organization's Portfolio for Growth*

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Questions? Write to Deloitte CFO Journal Editor