Are Accountants and CFOs Killing Innovation?

By Alvin Lee, Web Editor, Featuring Professors Gilles Hilary and Hal Gregersen

What can you do when penny-pinchers get in the way of your disruptive ideas to make necessary, often disruptive, changes in your company?

When Dell announced in February its decision to take the company private in a deal estimated at US$24.4 billion, founder and CEO Michael Dell said in a statement that the move was part of the strategy to "continue the execution of our long-term strategy and focus on delivering best-in-class solutions to our customers as a private enterprise."

One could have added that the deal was necessary to give Dell the breathing space it needed – away from the demands of shareholders and the market – to re-boot its strategy and recover its profits from its bread-and-butter PC business, which have been badly hit by sexier, more innovative products such Apple's iPad and Amazon's Kindle.

For big corporations – regardless of industry – making disruptive changes isn't a question of money: many have substantial budgets and can ride out the disruption. It's a question of mindset and how you position the innovative disruption on the balance sheet– and that can be the downfall.

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INSEAD Associate Professor of Accounting and Control, **Gilles Hilary**, in a research paper entitled "**Does Accounting Conservatism Impede Corporate Innovation?**", makes the case that firms with a greater degree of accounting conservatism are less innovative because of, among other things, the requisite accounting practice of immediately provisioning for future losses. Hilary writes: "The principle of accounting conservatism is to recognise losses as soon as they become probable but delay the recognition of profits until there is a legal claim to the revenues generating them and that revenues are verifiable."

Hilary adds, "The negative effects of accounting conservatism on innovation activities are more pronounced…when the pressure from short-term institutional investors is greater."

The Long Term View

The pressure to meet quarterly and annual financial targets is indeed great, says **Hal Gregersen**, Senior Affiliate Professor of Innovation and Leadership at INSEAD, but it did not deter innovators such as Amazon founder and CEO, Jeff Bezos. "It's important to remember that every major risk that Bezos has had Amazon take, the markets have actually been very negative when he takes the risks," Gregersen told INSEAD Knowledge in an interview during his appearance at the Unleashing Innovation conference in Singapore in February.

"When Amazon went from just selling books to building massive full-sized warehouses to hold more than books because they were spreading beyond that product, the markets thought he was an idiot for investing the money in that sort of capital expansion; we know the story there – it worked."

The markets crushed Amazon stock on two other company announcements: the move into e-readers (Kindle) and cloud computing; the bets paid off both times. Sales have more than tripled from US14.85 billion in 2007 to over US$48 billion in 2011, illustrating the benefits of taking the long-term view that Bezos often talks about.

It is well-known that Bezos includes in every Amazon annual report the company's 1997 letter to the shareholders, reminding them that "It's All About the Long Term". Among many points made in that letter, Bezos states quite clearly: "We will continue to make investment decisions in light of long-

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term market leadership considerations rather than short-term profitability considerations or short-term Wall Street reactions."

Innovation Exemplified?

Hilary wrote in his research that "cash-flows generated by innovations in firms with more conservative accounting have shorter horizons," and that "the negative effects of accounting conservatism on innovative activities are more pronounced when firms operate in innovative industries."

Hilary adds, "To encourage innovation, accounting should be facilitating the tolerance of failures at the initial stages of risky projects. This is particularly true when managers are already under strong pressure to deliver results quickly."

In that respect, CEOs and CFOs alike have much to learn from Amazon. The constant innovation that happens at the Seattle HQ churns out products that contribute to the aforementioned revenue streams. Perhaps more importantly, Bezos' courage to think long-term in such an innovative and high-tech industry such as the one that Amazon is in has minimised conservative accounting's negative effects on innovation.

All well and good, but you still have to convince the CFO whose job, after all, is to be cautious.

"You get a CFO often coming in to a bright new idea using language like, 'The marginal cost of our equipment can deliver something far cheaper than the total cost of this new investment,'" Gregersen elaborates. "So I'm going to use my marginal cost logic on you to say, 'Don't invest the money, CEO. It's not a good idea.'" As a result, a company misses out on what could have developed into a long-term cash cow, much like the Kindle has for Amazon.

Can You Teach Innovation?

That is not to say that CFOs and accountants are a guaranteed death sentence for innovation.

For his book, "**The Innovator's DNA**", Gregersen gave the example of Mike Collins, founder of venture capital and crowdfunding firm Big Idea Group. "Mike told us about hiring a CFO to make sure that they were making wise

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financial choices in the company. He said that the CFO's creativity skills were close to zero when he came into the system."

"But over the course of over nine to twelve months, just by being around others who think differently and act differently, he said the CFO's creativity went up to about 30-35 percent, which is about as far as it needed to be because when he was sitting at that senior executive table, he could not only provide input about the numbers, he could also interpret the numbers strategically and help the company to go in a different direction. So, in that kind of situation, where the culture itself was pretty innovative, it helped the CFOs elevate their creative capacity."

But what about CFOs who work in companies that do not have an inherently innovative culture? How should such CFOs go about becoming more innovative to help the organisation?

"I think I would write down four or five minutes every day all the questions I had about a problem, and it would lead to new questions which will create new solutions," says Gregersen. "I'll think about places I can go to watch and observe situations which might give me some insight about the issue. I would identify three or four people outside my industry, in a different geography perhaps, and talk to them about their perspective on the problem."

"If I do those sorts of things, and then I meet with the senior executive team four or five weeks later, I'd be stunned if that CFO wouldn't walk into that room and deliver a different and better perspective on the problem than he/she would have otherwise. It's that kind of legwork/homework…it takes work! But it leads to creative ideas that help a strategic-thinking group of people to go in a new direction."

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