

APPROACHES TO BUSINESS INNOVATION AND TRANSFORMATION – THE ROLE OF CORPORATE GOVERNANCE

Jane Fiona Cumming, Article 13

EXECUTIVE SUMMARY

Can you think beyond new products and new services to entirely new business concepts – ones that meet deep customer needs in unconventional ways? Can you think of unconventional ways of recharging an existing business concept? Gary Hamel, *Leading the Revolution*, 2000.

Companies face a complex and changing market and operating environment – from the impacts of global conflict to the technological leaps of the information age; from the demographic challenges to world-wide health and education provision to the environmental impacts of climate change and water scarcity.

Multinational corporations and domestic business giants are increasingly expected by government and other elements of society to contribute to resolving these critical, yet apparently intractable, issues – a requirement recognised by parts of the business community in the 60 multi-sector partnerships announced during the Johannesburg Summit on Sustainable Development in 2002.

This business response is more than the responsive protection of corporate reputation. Leading companies recognise the importance of sophisticated (formal and informal) networks in the planning and delivery of appealing business solutions; and indeed, many multi-stakeholder partnerships may have unexpected and remarkable consequences, possessing the potential to transform the vision and strategy of the organisation.

In this climate of complexity, innovative practice in relation to global issues appears certain to become a central driver of competitive advantage in the coming decade.

Recent research by Article 13 in conjunction with SERM Rating Agency into the innovative activities of FTSE-350 companies has identified ten businesses that have embarked on initiatives which - albeit at pilot phase – represent stages on a path to business transformation: a direction confirmed by the ambitious vision statements they have conceived.

These strategic breakthroughs – identified in the report *Business Unusual*¹ - encompass innovations in product and service, the creation of new routes to market through partnerships and informal networks, and innovations in technology and business process – all backed-up by new strategic tools and measures to support forward-planning and measure and assure progress.

The innovations identified are not directly governance-related. However, in each of these cases, corporate governance procedures are critical to the generation and ongoing viability of the innovation. Key elements include:

¹ Jane Fiona Cumming et al, *Business Unusual*, Article 13, 2004

- Board training and development processes that generate high levels of awareness and understanding of critical global issues and their potential impact on the organisation;
- Risk management procedures that enable the board to identify strategic opportunities as well as recognize critical risks;
- Board structures that ensure stakeholder perspectives on company activities and performance are integral to the business decision-making process;
- Forward-looking approaches to the assurance of financial and non-financial information, addressing corporate capacity to handle complex global issues;
- Disclosure and transparency processes that facilitate more effective relationships with stakeholders, and hence support organizational learning and innovation.

The trend towards multi-sectoral partnerships identified in the research also hints at a further challenge to traditional governance procedures. These new networks (with shifting boundaries of activity and responsibility) will demand and inspire new approaches to the control of business risk as well as the management of complex accountabilities.

Innovation in corporate governance will become an essential component in the delivery of sustainable business concept innovation.

THE EMERGING MODEL OF BUSINESS INNOVATION

Peter Drucker's early contributions to the literature on business innovation assert that entrepreneurship lies in the careful analysis and exploitation of changes to a business and its external environment. Forget the "popular picture of innovators – half pop-psychology, half-Hollywood" that "makes them look like a cross between Superman and the Knights of the Round Table". Instead, Drucker suggests, "successful innovators are conservative. They have to be. They are not 'risk-focused'; they are 'opportunity-focused'."²

In *Leading The Revolution* Gary Hamel confirmed that the basis of business innovation lies in a sensitivity to the radical changes of the business environment: that business concept innovation is 'a capacity to create new wealth-generating strategies – strategies that are as revolutionary as the time we live in'.

It is Article 13's hypothesis that a new model of innovation through business concept invigoration is emerging in the UK. The source of these strategies, perhaps unexpectedly, are the key challenges found within the social, environmental and ethical issues that form part of the current 'corporate social responsibility' and 'sustainable development' debates (see Table 1).

The scale of change in today's business environment perhaps mirrors the transformations of the 19th Century. Then, the Industrial Revolution was forged by (and generated) a cadre of social entrepreneurs and philanthropists - in the company-towns of Bourneville, Port Sunlight and elsewhere – through the construction of a new model of business.

² Drucker P, *Innovation and Entrepreneurship*, Pan Business Management, London, 1985

Table 1 - Business-critical world issues

Global Issues	Role (and Expectations) of Business?
Political:	
Political agenda	<ul style="list-style-type: none"> • Delivery of millennium development goals • Public/private partnership
Conflict – and post conflict	<ul style="list-style-type: none"> • Responsible procurement and governance
Social:	
Poverty – inequality	<ul style="list-style-type: none"> • Generate secure employment • Provision of food, shelter, healthcare, education and training • Loans, micro credit
Education	<ul style="list-style-type: none"> • Access to mentoring, capacity building and training
Health	<ul style="list-style-type: none"> • Access, infrastructure for provision of health services • Development and distribution of drugs • Disease prevention • Provide adequate health and safety programme
Demographics	<ul style="list-style-type: none"> • Family planning and education
Technological:	
Technology – internet	<ul style="list-style-type: none"> • Access to technology (computers) • Use of technology / training / engagement
Ethics:	
Governance – corruption, crime	<ul style="list-style-type: none"> • Promote transparent governance • Abide by the laws (but unfair and unjust laws) • Reform of laws

Global Issues	Role (and Expectations) of Business?
Individual versus community versus global	<ul style="list-style-type: none"> • Act local, think global, promote access of local services/products • Staff involvement in the local community • Partnership development • Individuals working remotely • Restructuring of board
Environment:	
Climate change	<ul style="list-style-type: none"> • Carbon neutral • Energy efficiency and reduction
Water scarcity	<ul style="list-style-type: none"> • Water recycling and reuse
Waste / reuse / recycle	<ul style="list-style-type: none"> • Reduce waste, increase re-use and promote recycling – leadership • Develop products with less materials, energy
GMOs	<ul style="list-style-type: none"> • Collect and communicate more information • Implementation of precautionary principle
Cross over:	
Sustainable production and consumption (responsible consumerism)	<ul style="list-style-type: none"> • Communicate benefits of sustainable production • Improve labelling and communication of information of products • Maximise efficiency of products and consider by-products • Use components that have been produced in a socially and environmentally responsible manner

Article 13's contention is that a new model of innovation is emerging, rooted in the major national businesses and multinationals of the FTSE-350. Enlightened business leaders are recognising that business survival and growth requires them to address the current business-critical global issues. In doing so, unexpected successes – new product offers, new partnerships and new processes - are acting as a further driver towards this alternative approach to innovation, iteratively driving and drawing business to build financial capital alongside social capital.

OBSERVING THE INNOVATION

Article 13's research published in *Business Unusual* in February 2004 assessed the practice of forty companies selected from over twenty sectors within the FTSE-350.

A quarter of the businesses demonstrated evidence of significant innovation and potential transformation regarding the business-critical world issues, with community and health issues the most fertile area for business involvement and a number of programmes addressing climate change and sustainable production (see Table 2).

Table 2 – The Ten Innovators: Areas of Innovation

Company	Sector	Area of Innovation
Anglo American	Mining	Health and Community
BP	Oil	Climate Change
BT	Telecomms	Climate Change
Centrica	Energy Sales and other Consumer Services	Community
GlaxoSmithKline	Pharmaceuticals	Health
Kingfisher	Retailer – Department	General (process)
Tesco	Retailer – Food	Community
Scottish Power	Electricity	Community
Unilever	Food Processor	Sustainable Production
Waste Recycling Group	Environmental Control	Waste

Common aspects – relating to the companies' strategic positioning and operating environment - appear amongst the vanguard innovators. The 'early adopter' companies of this new route to transformation frequently operate in consumer environments with supply chains and customer bases in volatile countries, with product and process issues that contain significant social, environmental and ethical risks, and where resolution of the issues requires high levels of collaborative problem-solving and high levels of current uncertainty.

Many approaches are currently cautious; pilot studies exploring the potential of new operating methods and alternative approaches to market. British Telecom, for example, decided in the autumn of 2003 to examine the potential of developing a wind-farm on its own land due to the absence of alternative 'green' suppliers.

This proposal was designed to break BT's historic methods of energy use and reduce costs – transforming the resourcing of the organisation - as well as building its reputation by demonstrating the company's environmental awareness and responsibility.

Such apparently small-scale and piece-meal initiatives can represent part of a sustained and wide-ranging approach to the role of innovation in the delivery of competitive advantage – an incremental path to transformation. In the UK retail sector, Tesco, operating in a saturated market with limited opportunities to build new stores and a need for new and skilled staff, has piloted an approach to business development based on re-generation and social inclusion.

By developing what they term 'regeneration partnership stores', the company has been able to contribute to the regeneration of deprived areas, quantifying the new jobs provided and improvements in diet. The regeneration stores are the latest in a series of Tesco's apparently phased initiatives ranging from procurement and supply chain management to customer information and staff incentive programmes - collectively working towards sector leadership and transformation of its business processes.

The Tesco example also illustrates the critical role of partnership in enabling the implementation of complex projects and demonstrating sensitivity to the expectations of a wide range of stakeholders. The key to the effective delivery of the regeneration stores was the use of a phased pilot approach that generated learning through partnerships with local government and community groups.

A series of local partnerships are equally central to the delivery of Scottish Power Learning, the energy company's educational programme for work-place and life-skills. The programme was launched in partnership with the trade unions, extending its remit beyond Scottish Power employees to their families, retirees and also selected groups in the wider community – so contributing to the company's networks with key employment groups as well as building human capital in its operating regions. The programme now draws on the skills and networks of the unions, governmental bodies such as the Learning and Skills Council, NGOs such as The Prince's Trust, and small enterprises such as the Cumbernauld Theatre.

Operating in politically sensitive and economically deprived communities, the mining company Anglo American is another company paying careful attention to groups outside its primary stakeholders. Anglo American's subsidiaries have worked in partnership with local medical groups and NGOs to implement a series of initiatives to address serious community issues. For example, Anglo Coal's HIV initiative has increased condom usage and treated sex workers and their clients. Anglo American's managed operations have extended anti-retroviral therapy at company expense to HIV positive employees progressing to AIDS; and the company has now recognised publicly that the extension of interventions beyond the workplace into communities associated with its operations is vital for its sustainability.

Centrica's UK energy business, British Gas, received unfavourable media coverage in late 2003 following the death of an elderly couple whose power supply had been disconnected. This public pressure will be a key test of its long-standing relationship with Help the Aged, a partnership designed to make the lives of the elderly warmer and less isolated. Interestingly, BBC coverage of the case included comments from a Help the Aged spokesperson, who said: "I think the key issue here is that there is no system in place to flag up vulnerable people and though they [British Gas] knew there was vulnerability here they weren't able to tell social services," – her comments referring to the apparent implications of the Data Protection Act.

An innovative example of British Gas's partnership approach, looking beyond immediate delivery issues to the long-term health of its customer base, was its Benefits Advice scheme launched in December 2003. This pilot programme is designed to address the confusion experienced by pensioners trying to understand the system of claiming benefits.

The formation of more unexpected relationships are also illustrated by the Article 13 review; the partnership may even be the critical innovation that creates a new market or transforms the costs and opportunity to access a new market, for examples the clinical trials alliance with a generic supplier announced by GlaxoSmithKline the pharmaceuticals company,.

Other case studies illustrate the creation of customer value through new products and services. An environmental services company, the Waste Recycling Group, has generated a series of environmentally beneficial production processes which create new green products. These include a green waste composting alternative to peat based products, and the recycling and recovery of organic content of household waste for use as soil conditioner.

The food processor, Unilever, has boldly embraced the sustainability agenda. As its corporate communications state, "We are committed to contribute to sustainable development. We see this as a hard-edged commercial imperative because we will only be able to maximise shareholder value and prosper in the long-term if we operate in a much more sustainable way."

The multinational Unilever faces extraordinary challenges in translating its vision into reality. Its first step was to structure its initiatives across 3 areas where it has direct control and believes it can make a substantial difference: agriculture, fish and water. The agricultural programme seeks to ensure continued access "to the key agricultural raw materials, and ultimately to develop market mechanisms that allow consumers and customers to influence the sourcing of raw materials through their buying habits." Unilever's procurement innovation rests in the development of sustainability guidelines for its five key crops - palm oil, tea, peas, spinach and tomatoes – through a process of stakeholder engagement including a multi-stakeholder advisory board.

The global energy player, BP, has a similarly ambitious vision: "To do no damage to the environment" – a challenge that stimulates BP "to find innovative ways to manage our environmental impact at local, regional and global levels." BP's approach is multi-pronged, addressing climate change (through combinations of energy efficiency, flaring reductions and lower carbon products), biodiversity, water usage, waste and air emissions.

A critical activity stream for BP, leading the gradual transformation of the organisation to a position 'beyond petroleum', is driven by its challenge "to build a material and profitable renewables business." Wind power is the dominant business element, forecast to grow by 25% through 2010; yet BP also emphasises the use of solar power to reach the one-third of the population currently without access to electricity. BP emphasises the role of partnership in delivery, working with global funding agencies, NGOs and private sector organisations as well as managing the training of local people to install and maintain the solar products.

Underlying the majority of the 10 cases of innovation are leadership commitments to the creation of social, environmental and economic value supported by effective measurement and management processes – the tools and measures that help organisations to implement and deliver business transformation. An outstanding example of business process innovation is demonstrated by the retailer Kingfisher, which has introduced a 'Ladder' management model structured around a set of business-critical issues – a global agenda translated into the specific strategic challenges in the European home retail market.

Kingfisher's approach, published in detail in its Plan for Corporate Social Responsibility, is explicitly designed to enable different businesses within the group to innovate independently (reflecting their own market conditions) around a commonly accepted vision of the future challenges facing the organisation.

Kingfisher's shared vision and 'Ladder' approach is already delivering incremental changes to the group's activity. The results to date have enabled the organisation to share and report on best practice, so encouraging employees' individual creativity to think (and realise) the unthinkable. The test for the organisation is whether these immediate successes can generate a step change from a price-focused retail tradition to a responsible and sustainable competitive edge.

BUSINESS INNOVATION AND CORPORATE GOVERNANCE

The examples of innovation illustrate a wide range of approaches to socially-focused innovation: from a series of incremental changes to the fundamental alteration of a business's historic direction; from the creation of new products and services, to the formation of new partnership networks to develop and deliver the products and services, and to the introduction of new management processes that underpin the partnerships and product offer.

Several of the cases are small scale, the innovations still at pilot stage; yet a more important note of caution comes from the notable absence of publicly available evidence regarding the skills base and systems and structures that will be required to deliver the companies' stated strategic objectives. It is these capacities – individual and organisational competencies - which will be central to the businesses' ability to identify and exploit the sources for transformation in response to critical world issues.

And here governance - "the system by which companies are directed and controlled" (as the Combined Code defines the governance system) - plays its part. A recent *Article 13 Review of Corporate Governance Codes* identified a series of common themes amongst the plethora of guidance on governance mechanisms (see Table 3);¹ and it is apparent that within each of these areas, the approach to corporate governance will affect a business's ability to address its changing operating environment: the capacity of a board to respond to these challenges (and to generate the requisite skills, knowledge and effective processes amongst the organisation more widely) is a critical element in building a viable model of innovation.

Table 3 – Corporate Governance and Innovation

Corporate Governance Themes	Governance and Innovation
The rights of, and relationships with, shareholders; the role of stakeholders	Board structures that ensure stakeholder perspectives on company activities and performance are integral to the business decision-making process.
Disclosure and transparency	Disclosure and transparency processes that facilitate more effective relationships with stakeholders, and hence support organisational learning and innovation.
The responsibilities and key functions of the board	Board training and development processes that generate high levels of awareness and understanding of critical global issues and their potential impact on the organisation.
Auditing and accountability	Forward-looking approaches to the assurance

	of financial and non-financial information, addressing corporate capacity to handle complex global issues.
Internal control and risk management	Risk management procedures that enable the board to identify strategic opportunities as well as recognise critical risks.

The trend towards multi-sectoral partnerships identified in the research also hints at a further challenge to traditional governance procedures. These new networks (with shifting boundaries of activity and responsibility) will demand and inspire new approaches to the control of business risk as well as the management of complex accountabilities.

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CONCLUSIONS

The early agents of change identified in the *Business Unusual* research are straining beyond the immediate concerns of their business operations, carefully and imaginatively assessing the possible routes to creating value over the next ten to twenty years.

They face serious limitations – distrust and scepticism extending from the boardroom to the shopfloor, from the stock market to town halls and parliaments. Yet these companies are seeking to overcome scepticism with practical results – they are daring to think the unthinkable, work with the unexpected and create the unknown.

Returning to Drucker, the entrepreneur is ‘opportunity-focused’, not ‘risk-focused’. And it is increasingly clear that corporate governance has the potential to be a key facilitator in enabling the entrepreneur (and the entrepreneurial company) to identify, analyse and address the opportunities available in a rapidly changing world.

ⁱ Extract from Review of Corporate Governance Codes, Article 13, 2004, Section 2.2. Summary Themes

Overarching area	Areas covered within it
THE RIGHTS OF AND RELATIONSHIPS WITH SHAREHOLDERS	<p>Dialogue</p> <p>Protecting the rights of shareholders (OECD)</p> <p>Shareholder democracy (EU)</p> <p>Shareholder meetings / AGM</p> <p>Shareholder voting</p> <p>Anti-takeover</p> <p>Equitable treatment of shareholders</p> <p>Institutional shareholders</p>
ROLE OF STAKEHOLDERS	<p>Rights of stakeholders</p> <p>Stakeholder participation</p>
DISCLOSURE & TRANSPARENCY	<p>Process</p> <p>Content</p> <ul style="list-style-type: none"> - The financial and operating results of the company (OECD) - Company objectives (OECD) - Major share ownership and voting rights (OECD) - Members of the board and key executives, their remuneration and committees (OECD) - Material foreseeable risk factors (OECD) - Material issues regarding employees and other stakeholders (OECD) - Corporate governance statement (EU) Governance structures and policies. (OECD) - Business ethics and public policy (OECD) - Institutional investors (EU)
THE RESPONSIBILITIES AND KEY FUNCTIONS OF THE (DIRECTORS) BOARD	<p>Role and responsibility of the directors / board</p> <p>Composition of the board</p> <p>Structure of the board</p> <p>Meetings of the board</p> <p>Independence from management</p> <p>Systems</p> <p>Strategic responsibilities</p>

Remuneration

- Board responsibility and level of remuneration
- Procedure
- Remuneration committee (“Compensation committee” in the US)

Conflicts of interest**Accounting and financial reporting****Governance practice****Disclosure process****Stakeholders****Environmental and social standards****Non-Executive Directors (Board balance and independence)**

- Overarching responsibilities
- Strategy
- Performance, risk, people
- Time commitment
- Disclosure
- Senior independent director
- Skills, knowledge and training
- Defining an effective non-executive director

Information and professional development**Performance evaluation****Re-election****Chairman and chief executive****Chairman**

- Roles and responsibilities
- Defining the effective chairman

Appointment to the board**Nomination committee**

- Responsibilities
- Membership
- Duties

**AUDITING AND
ACCOUNTABILITY**

**Independence of auditors
Financial reporting**

Audit Committee and Auditors

- *Role and responsibilities*
- Internal audit
- External audit
- Audit cycle
- Communication with shareholders
- Information and resources
- Membership and appointment
- Meetings of the audit committee
- Remuneration
- Skills, experience, training

Whistle-blowing

**INTERNAL CONTROL AND
RISK MANAGEMENT**

Internal control
Policy
Implementation
System
Review and review process
Internal audit