

Connect and Develop

P&G's big stake in open innovation

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Abstract: This report explores P&G's "Connect and Develop" open innovation initiative. Its focus is to analyse this innovation strategy in the context of the formal academic theory, other P&G's programmes and the company situation. Its objective is to understand the impacts, challenges and problems of implementing a large open innovation initiative inside a corporate giant such as P&G.

Keywords: Procter & Gamble, P&G, Open Innovation, Connect and Develop, Innovation Networks

1 Introduction

Innovation is the main driver for economic growth and progress of companies. In the age of the internet, it assumes even greater importance as maintaining competitive advantage becomes tougher with technology that brings the world closer and collapses the concept of time and space. Procter & Gamble is a company that has been a pioneer in this field of innovation. They are global manufacturers and marketers of consumer products with complex operational networks. P&G have been able to maintain their position in the market by adopting various innovation techniques and strategies. This report looks at the innovation strategies adopted by P&G, particularly with a focus on Open Innovation. The report describes the theoretical framework of the innovation model the company has used along with its Innovation strategy and its management, followed by an analysis of the P&G Open Innovation model, its problems and challenges and our conclusions.

2 Theoretical Framework

2.1 Innovation networks

One assumes that innovation is a stand-alone concept which works well independently. In reality this is not true. To convert a good idea into a profitable product/service a lot more input from different people and different perspectives is required. Making innovation happen is about bring people or teams together in a creative and productive manner. In the era of globalisation with access to high-speed infrastructure and with teams on the move all the time, building, maintaining and developing networks becomes the key issue in the process of innovation.

Usually innovation is seen as core process with a defined architecture with external influences acting on it. However, in reality it is not such a simplified structure. It is far more complex than that. The path of knowledge around an innovation project is more complex and interactive, appearing like some kind of 'social spaghetti' where different people talk at different times about different issues. (Tidd and Bessant, 2008)

A network can be defined as a complex interconnected system or structure, which is used to get work done. A network consists of nodes or points of action which are occupied by

individuals, companies, research institutions, universities, governments, customers and so on. These networks are greatly affected by how economic activities are influenced by the social setup and the position that the nodes or points occupy in the network. Therefore, a network can be influenced in two ways, i.e. by the interaction within the network and through the differences in position of the nodal players, which can cause power and control imbalance.

Networks work best when the advantages of Co-specialisation, sharing infrastructure and standards and other benefits outweigh the costs of network governance and maintenance. (Tidd and Bessant, 2008)

The above mentioned innovation networks, are the conceptual grounds where the Open Innovation (OI) model emerges, thus they are a critical structure to understand P&G's Connect and Develop model.

2.2 Open innovation

In the traditional model of innovation, the focus was mainly on research and development laboratories, where invention of new concepts and technologies were carried out using internal and external sources of information. These R&D labs usually concentrated on bringing out new technologies for self-commercialisation. This process can be viewed in the form of a funnel, where a large number of varied ideas and concepts can be trimmed down to few of those concepts and ideas that best meet the requirements of the company. (OECD, 2008)

In recent times, companies have become more open with their innovation process, leading to revolution described as “Open Innovation” by Chesbrough (2003). This ‘open innovation’ model is a more dynamic model when compared the traditional model as there is much more interaction between knowledge assets outside the company as well as inside. Henry Chesbrough (2003) in his book “Open Innovation: New Imperative for creating and profiting from technology” defines open innovation as a concept in which companies must use ideas from inside as well as outside sources and find internal and external ways to reach the market in order to advance their technological capabilities. Open innovation combines these

concepts of inside and outside ideas into systems and structures so that there is some order in the chaos. In another book “Open Business Models: How to Thrive in the New Innovative Landscape” he defines open innovation as the flow of knowledge internally and externally such that it moves the process of innovation at a much faster pace and so that new markets can be found for the use of this innovation. Open innovation means that firms should start using ideas and technologies from external sources and knowledge assets to create new and improved products/services. In the process, they should let others use their unused ideas which in turn can become a profitable venture by itself. This process would require an open business model to be in place.

3 Innovation Strategy at P&G

One of the core strengths of the company is its Innovation strategy. Its CEO A.G Lafley believes that innovation is at the heart of P&G's business model. The company uses innovation to create value with retail partners, satisfy customers and to create new business models to maintain sustainable growth (Datamonitor, 2009). The company boasts of a range of industry firsts (Appendixes 7.1 and 7.2). P&G uses a unique design for innovation comprising of five major categories (Datamonitor, 2009):

- Defining innovation broadly
- Investing in innovation at industry levels
- Managing innovation with discipline
- Delivering innovation that builds consumer trust and loyalty over time
- Using global brands and an outstanding team of innovation leaders to lead innovation

One unique feature in P&G's strategy is that innovation is involved in every area of the product which makes contact with the customer, such as the packaging, the shopping experience, the in-home product usage experience as well as the product itself (Datamonitor, 2009). A good example is the company's family care business where the innovations are customer focused rather than technology focused. This means that each product offers customized benefits to meet different consumer needs. The company also involves its customers in the innovation process on a daily basis.

The company supports sustainable innovation, investing heavily in R&D to bring better quality products to the market. P&G's budget for R&D amounts to nearly \$2 billion an year: twice the amount spent by Unilever, P&G's biggest competitor. This proves the company's dedication towards sustainable innovation (Datamonitor, 2009).

3.1 Managing Innovation at P&G

Historically P&G's innovation strategy was focused on its internal capabilities. The company had minimal experience externally and was not involved with its competitors. The model used by the company was a traditional stage gate model (Heimberg, 2008).

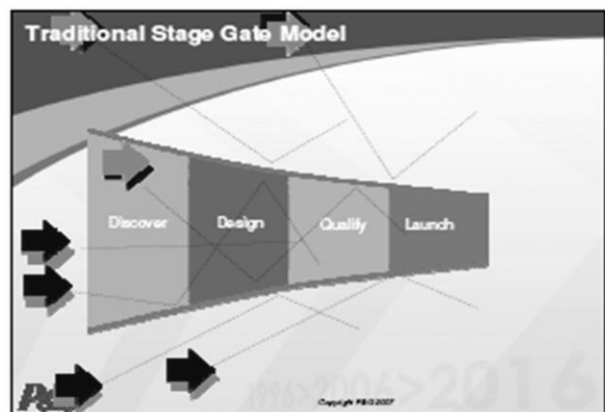


Figure 1, Stage gate Model (Heimberg, 2008)

This model (See appendix 7.5) helped P&G until 2000 when the company faced major financial difficulties. With the increase in the pace of innovation, costs, fast followers, constrained resources and more consumer demands the traditional model was unable to deliver the required results (Heimberg, 2008). The company required a "growth rate which exceeded the industry growth rate". This required collaboration with external sources (Lafley, 2008); commonly known as Open Innovation. This initiative was named connect and develop where the company collaborates with external sources for innovative ideas and technologies. When the process began the 10-15% of the innovations at P&G included ideas from external sources and today this has increased to 50%, resulting in the company achieving a 6% organic growth in an industry, which is growing at 2-3 %.(Lafley, 2008)

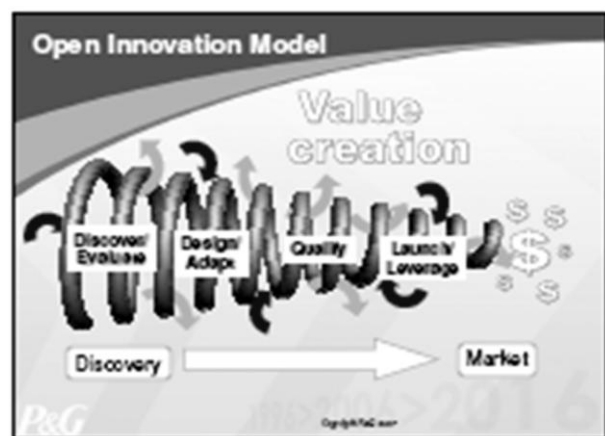


Figure 2, Open Innovation Model (Heimberg, 2008)

The company today works on a 'proudly found elsewhere' culture which has opened the door for many innovations. Although Connect and Develop is now considered the major Innovation initiative taken up by the company, there are several other strategies which drive the success at P&G.

3.2 Complementary P&G's Innovation Strategies

- 3.2.1 **User driven innovation:** User driven innovation mainly focuses on developing products based on customer needs. P&G carries out user driven innovation by engaging their customers as co-designers (Datamonitor, 2009).
- 3.2.2 **The Corporate Innovation Fund:** This can simply be described as an in-house venture capital firm which hands over successful innovations to the relevant business units in the company. The firm carries out the initial concept, design, engineering and qualifications work prior to handing over the ideas; and specializes in high-risk, high reward ideas (Datamonitor, 2009).
- 3.2.3 **Innovation Net:** A knowledge sharing solution at P&G, Innovation net provides access to 18,000 knowledge workers at P&G from the R&D to the Patent/Legal and Business Information systems (AskMe, 2001). The main function of innovation net is to allow users to catalogue, locate and maintain employee knowledge. This provides employees with the ability to take immediate action when required. (Haimila, 2002)
- 3.2.4 **Enterprise 2.0:** This is P&G's version of web 2.0 which is a set of web based software service that helps increase the involvement of employees in establishing and managing data. In addition to this, the company is also allowing its employees to personalize its web portal by adding RSS feeds of news and business information (Hines, 2007). This web-based service includes the customer and the suppliers web portals, online hubs for all the interactions with supermarkets, suppliers and technology providers around the world

Recent research has shown that innovation within the business can only occur if the structure of the business and the internal talent of the organization are structured to encourage collaboration between the employees and knowledge sharing (O'Hara, 2009).

Therefore, the above initiatives indicate the efforts taken by P&G to promote successful innovation within the company.

3.3 P&G's Connect and Develop Model Explained

From R&D to C&D

Besides all the innovations above, P&G has given great attention to product innovation. At first, like every other company, they had an R&D group which is good for exploiting knowledge and doing research inside the firm itself. However, the drawbacks are also obvious. There is no guarantee that all these blue-sky researches will be a success and it has high risk and cost associated (Bessant and Tidd, Table 12.2, 2007). Besides, only by getting out of the lab can researchers find and listen to customer wants and needs.

Initially, less than 10% of P&G technologies were being used in products. Which meant that many unused technologies were being kept hidden, much like antiques-valuable but useless. What's more, with knowledge increasing and refreshing at an exponential rate and much important innovations being carried out in small entrepreneurial firms (Bessant and Tidd, 2007), P&G realized it is impossible for them to complete everything alone while at the same time create satisfactory operating results for their shareholders. Things had to be changed. Therefore, P&G decided to introduce a new business model to cope with both the desire for external ideas coming in and own ideas going out. Instead of the traditional in-house research model "Research and Development", they formed a department called "Connect and Development" which is based on "Open Innovation".

The idea was to bring together external research institutions, customers, suppliers, individuals and even competitors to develop the market for new products. They established a web site (www.pgconnectdevelop.com) to communicate with the resources outside. The mechanism works like this: they simply put all their needs on this website in classified categories, and then anyone who is interested or has the solution could propose their ideas and get assessed by a specialized team. Payments can range from US\$10,000 to US\$100,000 (Bessant and Tidd, 2008). After this model has been applied, P&G is able to drive new innovation through collaboration with external partners in at least 50% of the cases (Sakkab 2002, cited by Dodgson, Gann, Salter 2006, P.6). Furthermore, this model seems to work

well: in 2004, P&G reported a 17% increase in volume, a 19% increase in sales, a 25% rise in earnings and a total shareholders return of 24% (ANOY 2005).

Thanks to the invention of the internet, another way for P&G to gain more external resources is to find solutions in other technology brokers such as Innocentive, Yet2 and NineSigma.

4 Discussion: Connect and Develop problems and challenges

Mixing elements from open innovation models, articulating multiple innovation networks and investing heavily in knowledge management tools, (i.e. Innovation Net) P&G has created its own novel way to deal with the new challenges of generating growth in mature markets through innovation. Nevertheless, they are not exempt from problems and challenges. Below are briefly described some of the most critical issues identified, that if not addressed properly might put in risk P&G's long term success.

4.1 The dangers of "outsourcing" innovation

Being able to access external knowledge and leveraging in this way, innovation sounds like a very reasonable strategy. Nevertheless, important risks lie behind it; Firstly "Lean innovation" might become fragile innovation and lead to a progressive loss of internal capabilities to develop their own innovations. This might damage in the long term their most important competitive advantage, their expertise to innovate. One example of this risk is in the aeronautical industry, where Boeing and Airbus are distributing their manufacturing and R&D capabilities so widely, that experts believe they might lose an important part of their critical knowledge over time. (Aron, Singh, 2005)

4.2 Managing the intellectual property and its negotiations in an open environment

Although P&G believes that connect and development will become the dominant innovation model in the twenty-first century (Huston, Sakkab, 2006), the drawback is obviously about how to protect its intellectual property. Case becomes much more complicated after the open innovation model is applied. In the past, all the innovations were kept inside of the company, and P&G only needed to decide whether to apply for the patent for a certain

innovation or not, fairly simple. However, in this model, there are many in-licensing and out-licensing of innovation and technology, which makes the protection of the intellectual property a big problem. The company needs to consider the most appropriate way to protect their new inventions. For example if the inventor does not have good protection, they are creating something that others can have for free (Docherty, 2008). Therefore, patents should be looked at closely.

Another problem that arises from this issue is how to manage hundreds or thousands of relationships with small technology providers (individual inventors, university departments, private R&D labs, etc.) that have no formal relationship in the long term with P&G and do not share the same incentives. Internal success cases (shown in appendix 7.3), like the "Magic Eraser" shows clearly the complexity of the Connect & Develop programme and how it must deal in an ad-hoc way to handle every case. Thus to innovate systematically in an open environment, huge transactional costs are usually incurred; cost that are not present when the innovation occurs in a closed fashion.

4.3 Issues about how to select and filter really innovative ideas

To cope with the complexity found in the C&D model, P&G tries to select technologies as mature and proven as possible (Huston, Sakkab, 2006). This is good to reduce implementation and technological risks, but it reduces the chances to customize and produce radical innovations because P&G's R&D department intervenes only in the final stages. This filter certainly limits the potential of the open innovation model, adding a cap on it, and also generates a problem because internal R&D capabilities are less exercised, aggravating the issue expressed in point 4.1.

4.4 Identifying the "Serial Innovators"

According to the Pareto Principle (80-20 rule) we should expect that most of the valuable innovations come from a very reduced group of bright individuals. This is particularly important when the challenge is to identify the "serial innovators" in an open innovation environment. This is because of the high number of individuals involved and the fact that they are not inside the company. For P&G identifying and nurturing this valuable group will become a key issue and an interesting potential competitive advantage.

4.5 Connect & Develop financial results

In spite of the fact that sales and profits increased over time after the implementation of C&D and some of its notorious success cases (Appendix 7.4), it is still not clear if this strategy has given P&G a significant advantage compared with their traditional model of innovation before the year 2000. Stock market trends indicate that P&G has followed a very similar stock price trajectory compared with its industry (Figure YYY) and so the real effect of C&D is difficult to calculate in financial terms. Regardless of all the original hype, C&D does not seem to be a real game changer in this business arena, or at least not yet.



Figure 3, P&G stock price evolution, Yahoo! Finance

4.6 The complexity of the system and its interactions

Connect and Develop and all the other innovation initiatives inside P&G, have created a complex set of structures and interactions, transforming the management of this system into a challenge by itself. At the heart of these interactions and the management of innovation, P&G have two critical positions; The "Technology Entrepreneurs" and the "Research Fellows", the first are the scouts, hunting new innovations outside of the company and later lobbying inside to bring them in. The second are in charge of the conceptual development and continuous refinement of C&D, acting as the back office of this intricate system.

To understand better this sort of "spaghetti model of innovation" and the challenges of its management a simplified overall view of the system is provided below in figure 3.

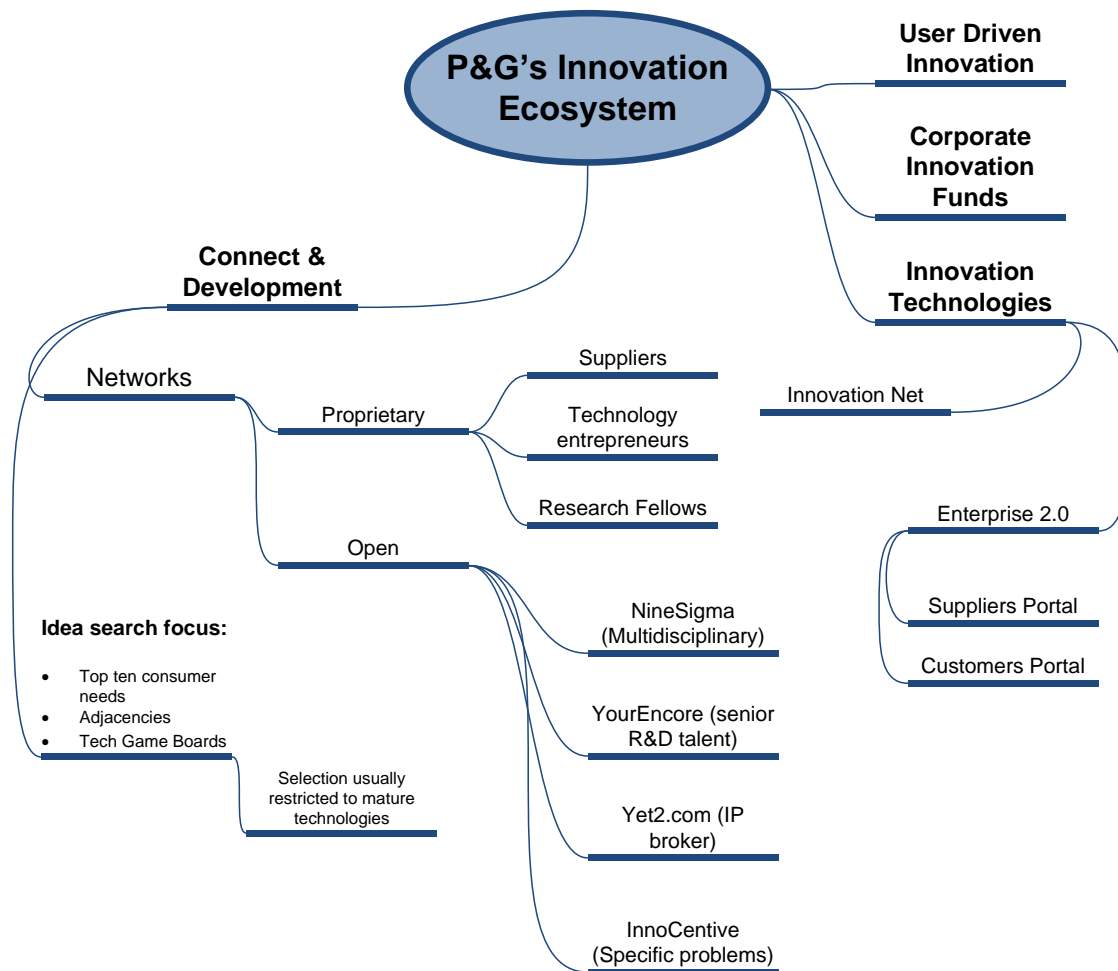


Figure 4, P&G's ecosystem

5 Conclusions

P&G's Connect and Development programme has become a clear business case when it comes to implementing an open innovation initiative inside a large company. They have created a completely new set of complex tools, networks inside and outside their company and invested strategically in this specific option to drive a major part of their innovation in new products. Thus, Connect and Develop represents a big stake and compromise in the long term, with a new business paradigm that has not fully been tested yet, and involves an intricate network of activities and concepts. On the Backstage of C&D, we find several interconnected innovation networks with customers, suppliers, internal staff and external innovation agents. Knowledge management tools are also embedded deeply in the structure, supported by innovation technologies based on information and communication technologies (ICT) such as web platforms like "Innovation Net" and other special software that help the work of the research fellows and technology entrepreneurs, who are the vital links in the Open Innovation implementation of P&G.

All this involves great complexity, new risks and challenges. So far, in terms of financial growth (Appendix 7.4) it seems that Lafley (P&G's CEO) has chosen the right path. Nevertheless, this is clearly just the beginning of a long journey that depends greatly on the skills to manage a heterogeneous and worldwide network of innovators without losing the vital internal capabilities and competitive advantages in this process, something that is yet to be proved.

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7 Appendixes

7.1 General Company Profile

Procter and Gamble commonly known as P&G started as a soap and candle company in Cincinnati, Ohio in the year 1837. Today it is a global manufacturer and marketer of consumer products. There are three main Global Business Units (GBU), the company focuses on: Beauty, health and well being, and household care (Datamonitor, 2009). The role of each GBU is to recognize common consumer needs, develop new product innovations. By successful innovations and marketing strategies GBUs also helps build the P&G brands. The other main sector of the business is the Global operations group which is subdivided into Market Development Organization and Global Business Services. Being the world's largest consumer goods company, P&G markets more than 300 brands in over 180 countries and functions in Europe, Asia and the Americas (Datamonitor, 2009). Some of the company's major products include Tide, Pampers, Pantene, Pringle, Gillette and Ariel (Carvin, 2009). The major strengths of the company include its focus on Innovation, Leading market position, strong brands portfolio and a diversified range of products. One of the major weaknesses of the company is its dependence on Wal-Mart. This can lead to a weakness in the bargaining power of the company especially considering that fact that 15% of P&G's revenue since 2006 is through sales to Wall-mart (Datamonitor, 2009). An increase in P&G product recalls were also noticed in the past couple of years and this can tarnish the brand image of the relevant products. The company should also expect to face difficulties due to Global economic changes, counterfeit goods and increasing regulations on products (Datamonitor, 2009). In the fourth quarter of the Fiscal year 2009 P&G faced one of the most difficult financial periods in decades (Learning Markets, 2009). The company has sold off its Folgers coffee business and in August 2009, signed a deal to sell its Global Pharmaceutical business. (Reuters, 2009).

P&Gs Major Competitors (DataMonitor, 2009)

- Unilever
- Avon Products, Inc.
- Colgate-Palmolive Company
- Henkel KGaA
- Kimberly-Clark Corporation
- Reckitt Benckiser PLC
- Energizer Holdings
- L'Oreal S.A.

7.2 List of P&G Innovations (DataMonitor, 2009)

- Tide: the first heavy-duty laundry detergent
- Crest: the first fluoride toothpaste clinically proven to prevent tooth decay
- Downy: the first ultra-concentrated rinse-add fabric softener
- Pert Plus: the first 2-in-1 shampoo and conditioner
- Head & Shoulders: the first pleasant-to-use shampoo effective against dandruff
- Pampers: the first affordable, mass-marketed disposable diaper
- Bounty: the first three-dimensional paper towel
- Always: the first feminine protection pad with an innovative, dry-weave top sheet
- Febreze: the first fabric and air care products that actually remove odours from fabrics and the air
- Crest White Strips: the first patented in-home teeth whitening technology

“P&G continues to be one of the few companies in the consumer product industry that create new categories and brands, new performance standards, and new definitions of consumer value. Swiffer and Febreze created entirely new product categories. Crest Pro-Health, Olay Regenerist and Definity, Pampers Baby Stages of Development, and Tide with Bleach redefined high performance in their categories. Olay innovation has created new

consumer experiences that are as good as/ or better than several-hundred-dollar department and specialty store brands” (DataMonitor, 2009). P&G has formed a unique design for innovation which has helped them maintain consistent innovations across the wide range of products the company manufactures.

7.3 Successful cases

Pringles potato crisps

In order to make the potato crisps more fun and attracting, P&G is thinking of putting animals, jokes on each crisp. One researcher suggested ink-jetting pictures onto the potato, nonetheless, it was very difficult because this need a very fast-processing printer and also provided different images and colours. For P&G, they also have to negotiate with an ink-jet printer company which will take at least two years. However, they discover a professor from Bologna, Italy, has already invented an ink-jet method for printing pictures on cakes through their European network. It only takes less than a year for P&G achieve double-digit growth from technology provided to market penetration.

Pampers diaper

Pampers diapers, with annual sales of more than 8 billion U.S. dollars, is the world's first disposable diaper brand. Nonetheless, the none-leaking underlying coating technology was actually not first invented by Pampers. It is transferred from a U.S Navy department which researches in the submarine technology.

Mr Clean Magic Eraser (The Osaka case)

This interesting case shows how scattered the product development process can be. Everything starts with a P&G's "technology entrepreneur" looking for new products in Osaka, Japan when he finds in the shelves and interesting new cleaning solution based on a novel sponge. After tracking the sponge providers, he ends up in BASF (German Chemicals manufacturer) who developed originally this solution as effective insulation for buildings. After negotiating directly with them P&G starts commercializing an

innovative new set of household cleaning sponges developed in close alliance with BASF.

7.4 Financials

All numbers in thousands

PERIOD ENDING	30-Jun-09	30-Jun-08	30-Jun-07
Total Revenue	79,029,000	83,503,000	76,476,000
Cost of Revenue	38,898,000	40,695,000	36,686,000
Gross Profit	40,131,000	42,808,000	39,790,000
Operating Expenses			
Research Development	-	-	-
Selling General and Administrative	24,008,000	25,725,000	24,340,000
Non Recurring	-	-	-
Others	-	-	-
Total Operating Expenses	-	-	-
Operating Income or Loss	16,123,000	17,083,000	15,450,000
Income from Continuing Operations			
Total Other Income/Expenses Net	560,000	462,000	564,000
Earnings Before Interest And Taxes	16,683,000	17,545,000	16,014,000
Interest Expense	1,358,000	1,467,000	1,304,000
Income Before Tax	15,325,000	16,078,000	14,710,000
Income Tax Expense	4,032,000	4,003,000	4,370,000
Minority Interest	-	-	-
Net Income From Continuing Ops	11,293,000	12,075,000	10,340,000
Non-recurring Events			
Discontinued Operations	2,143,000	-	-
Extraordinary Items	-	-	-
Effect Of Accounting Changes	-	-	-
Other Items	-	-	-
Net Income	13,436,000	12,075,000	10,340,000
Preferred Stock And Other Adjustments	-	-	-
Net Income Applicable To Common Shares	\$13,436,000	\$12,075,000	\$10,340,000

Figure 5, Income Statements 07-09, Yahoo! Finance

All numbers in thousands

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PERIOD ENDING	30-Jun-09	30-Jun-08	30-Jun-07
Net Income	13,436,000	12,075,000	10,340,000
Operating Activities, Cash Flows Provided By or Used In			
Depreciation	3,082,000	3,166,000	3,130,000
Adjustments To Net Income	(1,265,000)	1,769,000	921,000
Changes In Accounts Receivables	415,000	432,000	(729,000)
Changes In Liabilities	(742,000)	134,000	(273,000)
Changes In Inventories	721,000	(1,050,000)	(389,000)
Changes In Other Operating Activities	(728,000)	(712,000)	435,000
Total Cash Flow From Operating Activities	14,919,000	15,814,000	13,435,000
Investing Activities, Cash Flows Provided By or Used In			
Capital Expenditures	(3,238,000)	(3,046,000)	(2,945,000)
Investments	166,000	(50,000)	673,000
Other Cashflows from Investing Activities	719,000	547,000	(211,000)
Total Cash Flows From Investing Activities	(2,353,000)	(2,549,000)	(2,483,000)
Financing Activities, Cash Flows Provided By or Used In			
Dividends Paid	(5,044,000)	(4,655,000)	(4,209,000)
Sale Purchase of Stock	(5,689,000)	(8,180,000)	(4,079,000)
Net Borrowings	(81,000)	(2,815,000)	(4,190,000)
Other Cash Flows from Financing Activities	-	-	-
Total Cash Flows From Financing Activities	(10,814,000)	(15,650,000)	(12,478,000)
Effect Of Exchange Rate Changes	(284,000)	344,000	187,000
Change In Cash and Cash Equivalents	\$1,468,000	(\$2,041,000)	(\$1,339,000)

Figure 6, P&G Cash Flow 07-09, Yahoo! Finance



Connect and Develop, P&G's big stake in open innovation

Last Trade:	62.87 \$	Day's Range:	62.70 - 63.48
Trade Time:	Nov 25	52wk Range:	43.93 - 64.55
Change:	↑ 0.07 (0.11%)	Volume:	8,244,877
Prev Close:	62.80	Avg Vol (3m):	12,486,000
Open:	62.94	Market Cap:	\$183.25 B
Bid:	N/A	P/E:	14.65 x
Ask:	N/A	EPS :	4.29\$
1y Target Est:	66.25\$	Dividend:	1.72\$

Figure 7, P&G Long Term Stock price, Yahoo! Finance

7.5 P&G's Innovation or Initiatives Diamond

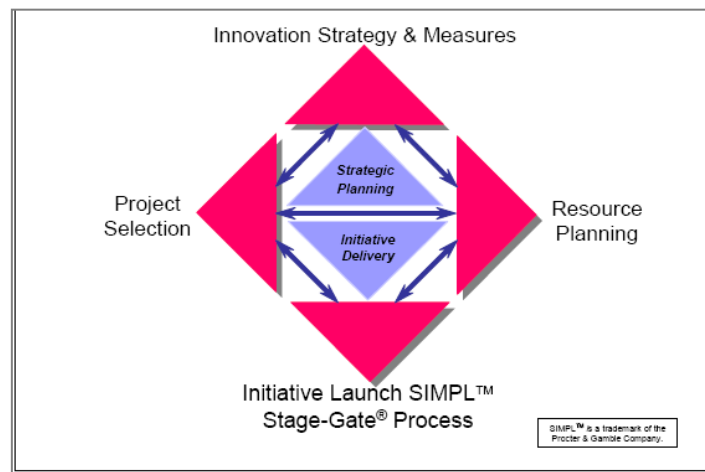


Figure 8, P&G's Innovation Diamond. (Cooper & Mills, 2005)

The initiatives diamond is used by P&G to guide their new product efforts and focuses the management's attention on the criteria important for success. The diamond can be divided into two sections where the top half involves strategic aspects which identifies the product innovation strategy such as goals, the mix of new products required to meet the goals and the essential resources (Cooper & Mills, 2005). The bottom half focuses on delivering specific new projects/initiatives. It is more operational and helps identify how the methods to manage projects successfully using P&G's idea-to-launch SIMPL method (Cooper & Mills, 2005).

SIMPL: Successful Initiative Management and Product Launch Model

This is P&G's version of a stage-gate model and is a method used to impel products from the idea phase to the launch and post launch phases.

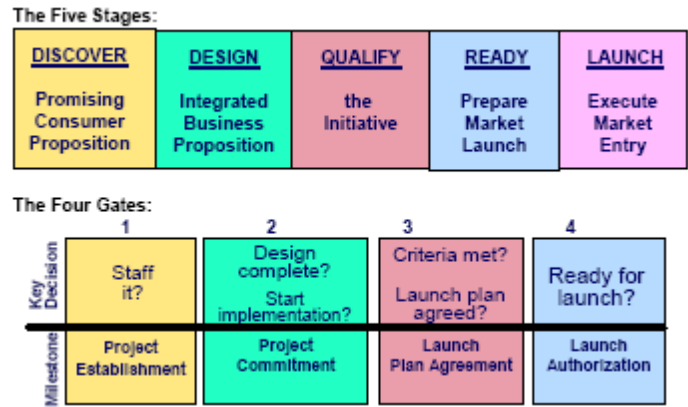


Figure 9, P&G's SIMPL Process (Cooper & Mills, 2005)

As can be seen from the diagram the SIMPL model has four main stages. These develop a set of current best practices and define the targets for the project team: end points. The four gates shown in the diagram includes team recommendation and a management decision (Cooper and Mills, 2005).