ICGN
International Corporate Governance Network

ICGN Viewpoint

Innovation: The Role of the Board and Investors

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Companies and investors alike recognize the importance of innovation for all stakeholders. The Business Roundtable convened a CEO Innovation Summit in December of 2018 that discussed innovation as a key driver of economic opportunity and a key enabler of a more sustainable economy.[i] At the same time, the UN Global Compact has emphasized the critical role of breakthrough innovation in accomplishing the Sustainable Development Goals (SDGs) and the $12 trillion market opportunity the goals are expected to unlock.[ii] Building from this imperative, it is a matter of good corporate governance for boards to consider in a structured way about how innovation can impact their company. As a matter of investor stewardship, and investors are encouraged to engage on the topic of innovation to better understand the long-term prospects for the business.

What is Innovation?

We would encourage a broad definition of innovation, with each board defining what forms of innovation might be most influential for a particular company. We define innovation *an activity that results in a new or meaningful improvement to an existing product, production or operating process that creates value.*

While traditional product innovation might be the most obvious, new business models, new human capital strategies, or new market channels could be critical at any given time. For example, the Sustainable Development Goals (SDGs) not only outline a range of social and environmental challenges, but they also present opportunities for innovative companies that can help to provide solutions to achieving these goals.

As with any board activity, a balance must be struck between appropriate board involvement and the role of management. The topic of innovation, however, runs through many of the board's core responsibilities including selecting management and succession planning, evaluation of board skill sets, appropriate compensation, and approval of the company's strategic plan. The board should consider the topic to include relationships with customers and suppliers necessary to provide the innovation. Prudent considerations include the company's ability to capitalize on innovation from suppliers and to deliver innovation to other stakeholders (including customers and employees).

Board Approach to Innovation as a matter of corporate governance

There are a range of reasonable approaches a board may adopt. Certain companies, for example, have specific board committees dedicated to issues of technology and innovation, whereas others may rely on consultants or non-board member advisors. ICGN does not advocate a specific board structure for companies with regard to innovation, and we recognize that company's approach will depend upon not only its industry and competitors but also on the stage of the company's own life cycle – and the life cycle of its products. So while approaches will, and should, inevitably differ from company to company, we believe that boards need to consider these basic questions carefully, so they can better engage with management, investors and other stakeholders on how to generate sustained success for the enterprise. To address the broad challenge of innovation the board needs an approach to the following three areas.

Strategy

While many companies may have a three or five year strategic plan, innovation requires a step back from that time horizon. The board should consider the life cycle of the companies' principal businesses and its internal capabilities. This includes consideration of the need incremental or radical change. Boards must also look to the future and assess whether or not the company might be facing a paradigm to one of its businesses on account of shifting technology or business models—and should consider these from both an opportunity and a risk perspective.

Predicting long term technology trends is certainly very difficult, especially for a time constrained board where members may have other commitments. At a strategic level, however, the goal should be to assess which are the key areas where innovation needs to be monitored and encouraged, so that the company is positioned for a ten-year (or longer) view. That then leads naturally to a consideration of how ideas for innovation get surfaced and nurtured. While there are multiple frameworks for managing innovation, the board should have a clear understanding of what it is expecting to get from innovation and what might be reasonable time frames and methods for review[iii].

People

The consideration of human capital applies to both the board's self-evaluation and the evaluation of management. The board should assess its own capabilities, including if its composition provides the right people with enough first-hand knowledge to understand the relevant trends. It is also important to provide some form of training or continuing education for the board as a whole to oversee innovation effectively. While each board member does not have to have expertise in all the relevant end markets and technology, the board should have sufficient coverage of markets and technologies to evaluate and probe the information it receives from management.

Investors also believe that the board should understand from the CEO how innovation will be handled throughout the organization. This includes consideration a human capital strategy that can provide a sufficient diversity of viewpoints to understand how employees approach the evolving marketplace. Boards should ask whether or not innovative people want to work at the company -- and why. Ultimately the challenge is to provide the right balance and mix of people from inside the organization to provide continuity versus people from the outside that might give new perspective to a company's thinking. In this context it is important to have an adequate feedback loop that seeks to gather new ideas from both inside and outside the company, as well as a reasonable development process for capitalizing on that input. These issues might factor into board hiring and compensation decisions, and it may be relevant for the CFO to be involved in creating the metrics discussed below.

While the specifics inevitably vary by industry and company, successful innovation requires a human dynamic to drive ideation. Employee participation has been shown to be a positive driver of innovation success in a variety of ways[iv]. Employees might participate in prize competitions for new products or services. For example, the company might sponsor an "intrapreneur" program if it is looking for new business models or ways to attack new markets. Employees might also require additional training or learning opportunities to develop ideas into substantive proposals. Employee recognition and incentives will also reinforce the innovation strategy. The CEO should decide on the best structure to drive innovation, which may include giving existing executives targets around innovation or, where relevant, hiring a Chief Innovation Officer. A specific innovation leader may be helpful for increasing focus on this area or bringing different groups in the company together, but there can also be dangers in this individual being sidelined within the company when other executives with decision-making powers are focused on achieving their budgets.

Measurement

Many companies find it difficult to manage and measure processes with less certain outcomes and long term or discontinuous payoffs. There is some truth to the R&D adage that ROI traditionally defined as "return on investment" can actually result in "restraint on innovation." There are a wide variety of frameworks and metrics tailored to innovation; the Appendix below includes a number of common metrics and their usage. Each company has its own innovation requirements and should make its own choices about how to measure their initiatives. However consideration of these general parameters below is likely to help investors understand the program better:

- How are the *inputs* measured? - Time, money and at which stages of the process. Breadth of involvement across the organization.
- How are *outputs* measured? – At earlier stages this could be new projects started and then later on new customers, revenues, or margins.
- How does this match with *incentives* in the company?

The examples below—anonymized cases show how this approach might be applied.

Example 1

A business to business company has a portfolio of products that serve different industry niches where each specific product is less than 5% of revenue. (Think of a specialty chemical company that serves multiple verticals—individual niche markets). The company decides to use a stage gate methodology to evaluate its ideas for new products, prioritizing the projects and then funding them as they demonstrate enough promise to move through the gates. The company measures the output using a vitality index of sales from products introduced in the last four years/total revenues. They also measure customer satisfaction on all customers vs customers that are using one or more of the new products.

Example 2

A consumer facing company is looking to evolve its portfolio of products and services. The management has identified a need to break out from their traditional "line extensions" of existing products (for example to make the same thing but 5% faster or no sugar added, etc.). The company gives a range of employees from different functional areas a time allocation to look for these new ideas. They measure the hours spent and the new ideas proposed. When they review the portfolio of ideas the company tried to bring to market they identify a targeted failure ratio of 50% [see Appendix], because they want to make sure they are taking enough risk, not just doing line extensions. The company has a recognition program for employees involved in coming up with new ideas. They measure the revenue growth from new products and the added gross margin on the new products and services in comparison to the cost of the innovation program over a multi-year time frame. After three years, they recalibrate the failure ratio to 30%.

Example 3

A consumer has reached a high single digit or market penetration in its home geography and targeted market segment. To take the company to the next level, the management and board agree that they will need to expand into adjacent verticals and geographies and be able to manage a materially larger workforce. They hire a Chief Innovation officer with a background in international geographies to help nurture new products. This person has a *budget and team they can use to support these growth efforts and will be evaluated by new product sales at a minimum level of gross margin. The company also approves a project with capital and time based inputs to help improve the human capital management function at the company. The benchmarks for this project are set around higher levels of employee retention and engagement, which the company projects will be necessary to increase the company's size in line with their strategic plan.*

Investor Engagement

The examples cited above show positive examples of how individual companies have approached innovation. They demonstrate that it can be important for investors to ask questions about how innovation is factored into company strategy, the long term health of the company and its decision making processes. There are some aspects of innovation which a company may reasonably consider competitive, particularly when it relates to a company's proprietary capabilities. The board and management, however, should be able to discuss with an investor:

1. How the company defines innovation and the key areas where innovation is changing the company and its industry.
2. What are the key work streams of innovation – is there a particular framework, a formal evaluation process, a selected group of metrics?
3. How do compensation and incentive structures promote the kind of innovation the company needs?
4. How is innovation enabled within the organization?

Investors have several starting points for understanding the role of innovation at the company. They can look at changes over time in the key qualifications for board members at the company and its peers. They can also look across companies at the innovation metrics used and what that might imply about the underlying innovation engine. Particularly as companies and investors are becoming aware of social, ethical and governance (ESG) factors as drivers of opportunity and risk, innovation can play a critical role in enterprise risk management and the generation of both cost efficiencies and new revenue streams.

More generally, investors should seek to better understand what the best builders of value in the industry are and encourage investee companies to place appropriate emphasis and resource to innovation. Inquiry about innovation also makes particular sense during management transitions, when a new strategy may be implemented. Innovation may also apply in the context of risks – both traditional competitive risks and sustainability issues that the company and its industry will have to confront.

It is perhaps the ultimate prosaic observation that the pace of change for businesses is accelerating. The board must grapple with how to oversee the firm operating under that reality. Investors should seek to understand how the governance process around innovation operates. Innovation may not be as routinely discussed as audit or the level of management compensation but adapting to change is likely to be one of the biggest drivers of long term value at a firm.

Appendix -Commonly Used Innovation Metrics

The list below has been compiled from a variety of corporate and academic sources. While not comprehensive, it is designed to provide a starting point for a discussion on appropriate innovation metrics.

Input Based

Time Invested in Certain Processes. This could be looked at from both the perspective of what did the company collectively spend time on, and from the perspective of what expertise did those spending the time bring to bear – marketing, customer service, engineering, etc.

Research and Development spending. A straightforward and widely used metric if often relevant.

Breadth of participation in a process. How many different parts of the organization were involved with new product ideation or customer insight or later development stages.

Ideas developed. There can be variations on this looking at sourcing, for example, developed internally vs externally. Developed is also subject to definition or refinement, perhaps with different phases of development. Where applicable there may be a physical manifestation like a prototype given to some trial customers or a beta trial of a new service.

Capital and time invested in different types of innovation, improvement of existing products lines, new products under existing brands or non-core “moon shot” innovation projects.

Time measurements of innovation cycle. Time from idea to prototype. If it is customer requested features, then time from request to roll out. Time to move through versions of a stage gate process. Time invested before ideas are killed, with the idea being that it is good to try things and fail but failing fast is better.

Failure Ratio. The percentage of attempts at a new process, product or other innovation that fail. A certain level of failure must be expected when taking sufficient risk, so a failure ratio that is too low indicates that the company might need some more ambitious goals. This metric would likely be most helpful in relationship to industry peers or benchmarks.

Output Based

Vitality Index. Sales from New Products/Total Sales. A metric that offers and objective ratio on the revenue impact from new products.

Customer Satisfaction. Are users of new products satisfied overall and more satisfied than other customers? In some instances, it may be a reputational measure, for example, and advertising firm might simply measure whether its potential clients believe it to be “innovative.”

Number of new products or services launched.

Revenue potential of products in the pipeline or launched in a certain amount of time. Note that this differs from actual revenue generated in much the same way that a sales manager might track both the pipeline of potential deals and the deals actually closed.

Market share. If this can be directly attributed to the innovation, it can also be analysed relative to innovation spend of competitors to measure the overall effectiveness of the innovation process, i.e. we are gaining market share despite a lower R&D spend per employee.

Patent counts.

Employee result. Could be an employee training as in lean manufacturing or an employee engagement measure.

New customers added by a new product or service offering. Could also be measured as a growth rate of customers or a certain kind of desirable customer, for example, customers of this new product tend to become omni-channel customers. Could also look at adoption or licensing by B2B partners that then reach a final customer.

Gross margin on new products. Could also measure products priced at a premium to competition. The concept is to measure to what degree a differentiated new product has pricing power which should drive gross margin.

Cost savings on a new process. Might need to be calculated from a benefit like lower customer churn, lower voluntary employee turnover, or direct material cost savings.

Return on Investment. Keeping in mind an appropriate time frame, the allocation of capital to innovation should have some bearing on returns at a portfolio level. It is worth noting that returns are often very hard to estimate beforehand with any precision.

ICGN Viewpoints

ICGN Viewpoints are produced by Secretariat and by our member-led Policy Committees. While not defining a formal ICGN position on the subject, they provide opinion on emerging corporate governance issues and are intended to inform and generate debate. This ICGN Viewpoint was drafted by David Silverman, a member of ICGN's Board Governance Committee, and the Committee has contributed to the review of this document.

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[i] https://www.businessroundtable.org/leadership-in-innovation
[ii] https://www.unglobalcompact.org/take-action/action-platforms/breakthrough-innovation
[iii] For one overview of innovation processes and metrics, see Hao et al. Signposts of Innovation. (2017).
[iv] For a full discussion, see Belloc. Journal of Economic Surveys (2012) pg 852-853.