Board of Directors Role in Corporate Innovation

The late Steve Jobs once said:

“Innovation is what distinguishes between leaders and followers”.

The main role of the Board of Directors is to make sure the organization has a winning future ahead, and this requires a solid innovation process.

It is a common misconception that “innovation” is synonym for “technology”. Not necessarily. Innovation is making sure that the business will stay ahead of future changes in its ecosystem, ideally drive these changes. Innovation can be applied to new customer service process, cost reduction, new business model, new distribution channels to name a few. Southwest Airlines, Domino Pizza and Uber are few examples of such innovations.

First, let’s have a brief review of the common board roles before we discuss the innovation angle.

Traditional Governance Duties of Corporate Boards

Different types of entities (public company, private company, start-up, nonprofit, family business, among others) and different industries may have slightly different board structures. Let’s start with a brief description of the board of directors’ roles in general, and then drill down into their involvement with the innovation process.

- Governing the organization by establishing broad policies and setting out strategic objectives.
- Selecting, appointing, supporting, and reviewing the performance of the chief executive. (The titles of this position vary from organization to organization: they are most often chief executive officer, president, or executive director.)
- Terminating the chief executive.
- Ensuring the availability of adequate financial resources.
- Approving annual budgets.
- Monitoring the organization's performance and reporting it to the stakeholders.
- Setting the compensation and benefits of senior management.

Governance Duties with Implied Innovation Aspects

The participation of the board of directors in the innovation process varies depending on the nature of the company and the industry it plays in.

A start-up is all about the new product or service the new business was founded to develop and commercialize. In this case, the board of directors is very engaged in the innovation strategy and its execution.

Most boards of directors of larger established companies shy away from being too involved with the innovation process because they view it as a day-to-day operational topic. This is a BIG MISTAKE because innovation is such a crucial part of an organization's survival and future success. Nevertheless, even if they don't devote targeted attention to innovation, several governance duties of the board encompass implied innovation aspects, such as: strategy, risk, auditing, management performance, compensation, and CEO transition, as these are critical to every business at every stage of its growth. Let's look at each implied innovation element in greater detail.

Strategy

Boards rate highly their role as company strategy reviewers. These strategic issues often are discussed when major investment decisions come up for which board approval is required. A soda company doesn't seek board of directors' approval for every new flavor it creates, but it will most likely require the board's approval if the company's management recommends adding solid food to its strategic portfolio. The board is entitled to expect management to communicate its actual priorities and provide an estimate of the resources the company is planning to invest by type of innovation.

Risk

Boards have a fiduciary responsibility vis-à-vis shareholders to be the guardians of the company's risks. In some cases the risks are financial in nature, and the board's audit mission aims to address them. In certain industries and companies, other risks—among them environmental risk and political risk—are regularly reviewed and assessed by the board. In some industries—especially the pharmaceutical industry—the product liability and class action risks are important subjects of board review. Other companies identify innovation risks, which usually fall into three categories. The first category is the risk of not innovating enough and being bypassed by a competitor's new product or service. The second category is the risk of innovation execution, such as in meeting the R&D schedule and budget. The third category is the risk of market acceptance of the new product or new service. Board members themselves do not always have to see the emerging trends, but their governance function requires that they ask management to keep a lookout and report to them.

Auditing

Besides their traditional focus on financial audits, boards are gradually extending the range of their supervisory auditing missions beyond the financials. As mentioned before *innovation is a critical ingredient to business survival in the long run*; thus, innovation should be included in the list of the board's auditing missions. It is indeed within the legitimate role of the board to ask top management to set a few critical innovation effectiveness measures, which its members can regularly review and discuss thereafter with management. In some industries, the level of R&D expenditures—in absolute terms and as a percentage of sales—is a classic example of one such innovation input indicators, but there are others to be considered. Similarly, a frequently measured innovation output indicator is the percentage of sales achieved through new products.

Management Performance

A critical role of the board is to evaluate the performance of the CEO and the top management team as a basis for decisions on compensation packages and for the replacement of the CEO. To do this, some companies use elaborate sophisticated formulas that resemble the traditional balanced-scorecard concepts used many human resources departments. CEO scorecards usually combine financial figures and targets—generally based on company growth, profitability, and stock price, among other metrics—with other qualitative or quantitative measures or specific goals pertaining to the company's strategic initiatives and priorities: for example, specific turnaround targets, progress in globalization efforts, capital efficiency improvements, etc. Companies that depend on the introduction of critical—that is, "make or break" new products (think of Boeing with its 787)—generally include the review of these large projects in the board's deliberation. In these companies, the board will most likely make the compensation packages of the CEO and the top management team contingent on the successful completion of critical new product innovation milestones.

Compensation

The Compensation Committee on most boards of directors is responsible for overseeing the company's compensation programs. These include, among other subjects, developing and monitoring a strategy/philosophy regarding executives' compensation; ensuring regulatory, accounting, and listing compliance; reviewing and approving compensation adjustments for the CEO and executive officers; assuring the competitiveness of executive compensation.

When structuring the executives' incentive plan, a possible metric to use could be the R&D/sales ratio; another possible one is revenue from new products as a percentage of sales.

If part of CEO compensation is based on stock performance, provide an incentive based on the average stock price for five years or based on quarter-over-quarter stock price increase. This will be an important signal to the CEO regarding the value of long-term stock performance (which could greatly be fueled by the company's innovation performance) versus short-term stock performance, in which case the CEO will be incentivized to improve short-term results while sacrificing long-term goals.

CEO Transition

The selection and recruitment of a new CEO is undoubtedly one of the board's most visible and difficult responsibilities. A subject that has captured a lot of attention from the business media is the decline in a CEO's tenure at many an industry giant in recent years. People—CEOs included—spend less time on the job than they did fifty, or even twenty years ago.

Boards generally feel more comfortable with the more predictable CEOs than with the innovative one. But, new CEOs often need to challenge the status quo and set the company on a new course to maximize a new growth opportunities.

The Advent of Innovation Committees

Companies must reinvent themselves (or die). IBM (NYSE:IBM), Siemens (DAX:SIE), and Wipro (NSE:WIPRO) bear only the faintest resemblance to their founding forms—and boards ought to be at the forefront of such transformations. New products are the province of R&D teams, but new strategies and structures are squarely in the board's domain.

Some boards have taken the principle further by forming their own innovation committees. The directors of Procter & Gamble (NYSE:PG), for instance, have established an Innovation and Technology Committee; the board of chemical maker Clariant (SWISS: CLN) has done the same, and Pfizer (NYSE:PFI) has created a Science and Technology Committee.

Diebold (FRANKFURT: DBD), a $3-billion company that makes ATMs and a host of related products, was founded in 1876, way before ATMs were invented. The company has survived far longer than most major manufacturers because of a readiness to embrace new technologies, and its directors hope to ensure that the company incorporates new technologies to survive another hundred years.

The impact of innovation on shareholders' equity can be best demonstrated by this Intel example. Intel announced on September 18, 2017, their progress on a new generation of technology called 10nm, information about its technical details, and their commitment to shipping the first commercially available product in this technology. Intel stock immediately responded with a 34 percent increase in less than two months, which added $60 billion to its shareholders equity.

Summary

- Innovation is a major ingredient in a company's competitive and survival strategy. Therefore, it must be one of the boards of directors' governance responsibilities.
- However, BoD members and committees need to restrict their involvement to a "Nose in–Fingers out" process.