Governing Innovation: It's Not an Oxymoron

By Elaine Eisenman and Melissa Means

Typically, governance and innovation are seen as opposing concepts. We tend to broadly think of governance as ensuring adherence to a set of guidelines or rules regarding norms and behaviors, and we think of innovation as creatively rethinking or breaking those rules to inspire new ways of doing things. With the pace of business today, it's clear that market forces are pushing companies to develop new and ever-evolving long-term strategies. As many companies are discovering, innovation is imperative for ensuring that a business is able to compete in today's turbulent marketplace.

Fostering innovation has not historically been at the top of the list of board responsibilities, and many may assert that it is decidedly not a charge of the board. In truth, beyond pharmaceutical companies and pure product development companies, it's rare for companies to have explicitly stated, prioritized, well-designed, and ongoing innovation processes. However, guiding business strategy certainly is a primary board duty, and true innovation cannot be separate or distinct from strategy.

We know the ability of the board to focus on its primary mission of protecting shareholder interests can suffer when boards spend too much time on lagging business indicators, risk mitigation, and business as usual. Unfortunately, too many board members believe that their chief role is to avoid any risk, which is an impossible task. Indeed, opportunity cost may be the biggest risk of all in the current environment. It is essential that the board be forward-looking and focused on long-term growth versus quarter-to-quarter results.

This position was illustrated in a 2014 McKinsey & Co. study that found that companies that excelled in five different categories—company investments, earnings quality, margin quality, quarterly management, and earnings-per-share growth—grew 47 percent more, on average, than companies that scored at the low end of the scale. These companies also spent about 50 percent more in research and development and increased spending in this area during the financial crisis. Those results make a compelling argument for why board members need to help drive innovation.

Assign Processes

To be effective, having processes and shared definitions in place that both the board and management team can rely on for guidance is an excellent step. Consider what having an explicit innovation process entails.

First, the iterative nature of innovation—ideas, experimentation, rapid testing, quick learning, and then subsequent iterations based on that learning—suggests that many innovation initiatives should be occurring simultaneously. For the board to increase its understanding and provide the right level of support, it should receive regular updates from management on various innovation initiatives at every meeting, allowing time not only for reporting but for expansive discussions. Doing so allows the board to remain knowledgeable about what is happening in the company, how strategic initiatives are enacted, and where the company stands on its long-term plan.

An additional benefit is that such discussions invite board input and opportunities for board members to provide their outside perspectives. This level and frequency of engagement also sends a clear and continually reinforced message to senior leadership about the critical nature of innovation to the company's future success.

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Another method for bringing process to the organization's innovation engine is for the board to request the development and sharing of an innovation pipeline during these regular board updates. This can be very similar to the marketing and sales pipelines and dashboard reporting that routinely express relevant data and milestones for strategic initiatives.

And no process is complete without a common understanding and cultural reinforcement of how the company embraces learning from failure. This is a key point for a board that wants to actively encourage new ideas. The aim here isn't to avoid failure, but to manage the cost of failure and to create a culture where failure is seen as an opportunity for learning and growing.

Encourage Talent

In every company there are individuals who are more naturally attuned to being innovative—they see the big picture, are potentially less risk averse, can think about new and different ideas, and can get into the details without being mired in them. How can a board ensure that the executive leadership team includes these individuals in the innovation process?

Beyond planning for the next CEO, visionary boards see succession responsibility in broader terms by identifying and encouraging the development of their company's next generation of leaders to think creatively and to bring forth and support innovation. These boards think about leadership development from both a micro and a macro perspective. What are the critical leadership competencies that will drive the company's long-term strategy? Who in the company possesses those qualities? If they don't exist, how can they be developed—or must they be recruited?

By insisting on understanding the competencies of people in the organization and looking for big-picture thinkers and experimenters along with planners and implementers, the board reinforces what's important for the company. In this way, the board can facilitate defining for the management team who can deliver on the long-term strategy. Similarly, the board can also work with management to encourage developing this strategic talent pipeline.

Every company will approach this in a slightly different way, but it is critical that board members think about merging the development of people with high potential with the company's innovation process. For example, choose up-and-comers for an idea creation task force, and reward those with the best ideas with an opportunity to leave behind his or her prior role and lead the new project team. To keep the cycle going, that prior role can be filled with another person with high potential whose skills can be developed.

A note of caution: boards need to take care that management ensures any significant extra work is not in addition to current roles and responsibilities, which will doom the project and stall any momentum. Likewise, ensuring projects are well funded with budgets that are earmarked to support innovative initiatives is extremely important.

Track Progress

One challenge with innovation is setting the right metrics for determining success. To start, it may be helpful to look at other evaluation mechanisms that have proven to work for the company. However, the board should avoid the tendency to go toward very specific, results-focused metrics just because they're easy to quantify.

With innovation tracking, revenues from new products may be important, but by no means will they be the most important marker, especially in the short term. Milestone-based objectives that can measure an idea's movement through the concept to the design and implementation stage can be just as important, if not more so. Likewise, the careful post-mortem analysis of a failed project, complete with takeaway lessons for future projects, may be a measurable milestone. No matter the metric, effective assessment should include realistic timing and predefined measurements of progress.

While setting and achieving quantifiable goals in this area is important as a base level of accountability, the board also has to maintain a position of flexibility and an ability to determine the quality of the company's innovation engine. Having those on the front lines of the innovation process deliver board updates provides an opportunity for active discussion about what is working and what is not, and can prevent the determination of success from boiling down to solely a numbers game.

Compensate for Success

The success or failure of a company's innovation journey may well lie with compensation. A reward system that encourages overly risky behavior will be just as damaging as incentive plans that fail to reward creativity, or those that are set up to discourage anything other than the status quo.

Just as boards should see to it that long-term funding is set aside for new projects, funds should also be allocated to reward for innovation. An ongoing budget structure that accounts for both allows the innovation process to become much more robust and failure-tolerant.

A well-rounded incentive plan will include some leading metrics based on common definitions of return on investment (ROI), including strategic markers, but will take pains to avoid an ROI-only trap. Such a plan will require accountability but offer flexibility in time frames and measures of success, and should be structured to be culturally consistent for the organization. Even simple recognition plans can play an important role in helping drive focus toward innovation initiatives. Compensation design should always be tailored to what matters most in the long term for the organization, and this is especially important with innovations that may determine a company's new strategy or direction.

Innovation can be a daunting topic, but thinking about scale is helpful. Not every innovation can advance a company to become Amazon-like. The real key is for boards to be explicit with their leadership team and shareholders in defining what they are trying to accomplish. With innovation, encouraging the dialogue, monitoring and rewarding progress, and aligning compensation in creative and relevant ways can help create a unique, forward-thinking culture that is right for the organization.

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