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The Fourth[1] Dimension of Risk Assessment; Innovation Risk
Boards of Directors should take note

If one was to ask a member of the Board of Directors of most companies about the innovativeness of their company, the typical answer would be that the company is very innovative and doing well, thank you for asking. At least that would be the response from those companies which make it their business to be, or want to be, innovative – as opposed to those who deliberately adopt a follow-the-leader strategy.

But the next question; how do you know your company is innovative – would elicit a more muted response. Non-financial metric information, which is required in order to respond to this next-level question, is often lacking. Metrics such as percent of revenue spent on R&D, or the percentage of new products on offer compared to total product offerings, are often used as a proxy for innovation, but are not sufficiently comprehensive to register most innovation activities. This in spite of the increasing risk associated with innovation as corporations' deal with fast-paced developments.

Simply put; Boards of Directors typically do not have the appropriate information to deal adequately with an assessment of innovation-derived risk. Often this responsibility is shared with the CEO but, based on most recent surveys, Boards are now more than ever attempting to grapple with this issue.

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- Both investments into innovation activities and outcomes achieved need to be tracked.

Appendices

A. Innovation Pipeline
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Innovation risk assessment is the subject of this White Paper! We present an approach which has the objective of providing a rationale for improved information on innovation risk to Boards of Directors and the CEO.

[1] The other three dimensions are; operations, financial and compliance in general.

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Who is responsible for innovation risk?

Business risk is gaining more presence at Board meetings as Directors try to deal with the subject of change and innovation.

The link between an aggressive innovation posture and a risk profile for the organization is now more evident and is seen as an important element of a Board's responsibility to shareholders.

Innovation, and its place in the organization, is seen as integral part of an organization's strategic plan and thus is among the decisions which a Board must make in the interests of shareholders. This is especially true in fast-paced technologically-advanced companies but, in principle, all companies are impacted by change and innovation.

A recent survey by Deloitte[2] found that 81% of companies surveyed have extended their consideration of risk from the three usual topics of operations, financial and compliance to embrace a fourth dimension; namely strategic and innovation risk. Risks which could have a bearing on the company's long-term positioning and financial performance were the primary concerns. Two thirds of companies surveyed say that the 'CEO, and/or a board risk committee, has oversight with it comes to strategic risk'.

As companies become larger, obviously the Board's view changes from one of examining strategic risk at an operations unit level to taking a higher-level view and leaving the business unit to assess its own strategic/innovation risk – but within a corporate framework that facilitates understanding at senior levels. In either case, there should be a commonality of approach to the task. In the same Deloitte paper, Eisabeth Pacaud, Associate Vice-President, Group Risk Management at Sanofi (a global health care company) makes the point that "strategic risk is one that directly impacts the company's identified strategic goals whether they are diversification, innovation, or emerging countries". Ninety-four percent of those companies surveyed state that their approach to risk has changed in the last three years.

There was mixed response, by geography, to the question as to 'who primarily determines your company's approach to managing strategic risk? Fifty-five percent of European respondents placed an overall responsibility with the Board or with a Board-level risk committee – whereas the 'Americas' had only 34% at the Board level preferring to task the CEO with this function (9% in Europe and 27% in the Americas).

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[2] Exploring Strategic Risk: A global survey, Deloitte and Forbes Insights – 300 respondents from the Americas, EMEA, and Asia/Pacific, 2013

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The majority of respondents were concerned with 'technology enablers and/or disrupters on the horizon that may threaten… the business model'. A clear indication of the potential impact of innovation on their corporation.

There was a sense that 'looking ahead three years from now, the innovation pipeline[3] is expected to emerge as a top risk-related strategic issue. Keeping the pipeline full is a challenge and implicitly adds to risk.

A related and relevant survey by Deloitte[4] concludes that 'though companies are aware of the pitfalls of focusing exclusively on financial performance, the ability of executives to measure and monitor performance through non-financial measurements appears to be 'inadequate '. Companies either do not have or are not sharing critical non-financial performance data with their boards. Only 29% describe their ability to track non-financial performance as either excellent (5 percent) or good (24%).

The drivers of innovation risk

The 'brand'.
Forty-nine percent[5] of respondents and 59% of those whose companies have annual revenues of over US$1billion - believe that companies are turning to non-financial performance metrics to help avoid damage to their reputations.

The accelerating pace of innovation.
Twenty-nine percent of respondents say that the need to make more innovative products and services is another force behind the increasing interest in non-financial performance metrics.

But J. Marvin Quin, SVP and CFO at Ashland Inc., a diversified chemical company, says[6] finding the right metrics is a continuing challenge. "We're trying to do more to measure and promote innovation," he explains. For example, "We are looking at the percentage of products sold that are new and using that to see how aggressively we are refreshing and updating our products"; not a new measure but again this is an indication of increasing concern with the pace of innovation.

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[3] Innovation pipeline – see Appendix A
[4] In the dark II: What many boards and executives STILL don't know about the health of their business, Deloitte, 2007 – updating results from a similar survey in 2004
[5] Exploring Strategic Risk: A global survey, Deloitte and Forbes Insights – 300 respondents from the Americas, EMEA, and Asia/Pacific, 2013
[6] Exploring Strategic Risk: A global survey, Deloitte and Forbes Insights – 300 respondents from the Americas, EMEA, and Asia/Pacific, 2013bid

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Lack of suitable accounting-sourced information.
Ultimately, says[7] Mr. Carver – of Bandaq -, "It's the non-financial performance metrics—employee commitment, effectiveness, and passion, customer delight and loyalty and the other sorts of process indicators that accountants haven't learned to measure—that can give you a better prediction of the long-term and sustainable competitive advantage."

When executives were asked who should monitor the financial results of the company, 80 percent said that the board and management should share responsibility. When they were asked about specific non-financial indicators, however, they said that in most cases monitoring should be done by senior managers, **except in the case of innovation** where more people said that the monitoring should be shared.

As with the earlier 2004 study this latest research again reveals a critical fault line between rhetoric and reality in the boardrooms of some of the world's leading companies. Many boards and executives are still in the dark about the health of their businesses.

Non-financial factors are widely regarded as extremely important drivers of success for a company, yet in most cases they receive considerably less attention than financial data from the board and senior managers.

The reasons for such a mismatch are easy enough to list. Reliable non-financial performance metrics - reliable in the sense that they absolutely correlate to financial performance - are difficult to discern.

Consistently tracking such "soft" issues as employee engagement, innovation or customer satisfaction is viewed as more art than science. Financial metrics seem more solid and familiar. 'Naturally, there is resistance', according to the Deloitte report. DSM[8], a highly-innovative Netherlands-based company, makes regular use of surveys to measure their employee interest in strategy and innovation.

Increasingly companies such as those we have researched[9] are concerned about their reputation. Examples include Starbucks – reference their most recent hire of a senior executive from Disney world; surely one of the world's best recognized brands. DSM – the Netherlands-based company – regularly surveys its stakeholders to get a non-metric information on the issues of customer and employee views on issues related to reputation and innovation.

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[7] ibid
[8] For information on these companies please visit http://www.corporateinnovationonline.com or www.innovationmanagementcenter.com
[9] ibid

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Innovation risk in larger organizations and SMEs

Risk management is the identification, assessment, and prioritization of risks whether positive or negative[10]. The process of portraying and communicating these risks at the senior management and Board level is the challenge at hand. Innovation-derived risk is at least, if not more important, than other risks such as financial or environmental-related matters which are normally brought to a Board's attention.

Agrium's[11] approach to reporting on innovation matters provides an illustration of how innovation risk should not be handled. Under 'Management' their view is that

- Subject to the oversight exercised by the Board pursuant to the ERM process, risks that are unique to our separate strategic business units are managed by the Presidents of those business units and their teams.

The message seems clear and that is that information related to risk from innovation, i.e. new ideas about to be invested in, are unwelcome at the Board level. At the same time the Chief Risk Officer has a stated responsibility of providing an oversight role on the traditional matters of environment, including internal Audit, Corporate EHS&S, and the internal control and compliance team. Even risks resulting from Agrium's compensation arrangements are highlighted. Risk due to innovation is less important?

Boards of Directors need to participate much more in the corporation's management of innovation. In fact, it is essential for the Board to have information by which it can discharge its fiduciary obligation to shareholders; that of assessing investments in risk, in innovation.

Knowing about 'failure' in innovation should be on a Board's agenda. Innovation often leads to failure but out of failure can come experiences which will, in time, move and organization into new markets with new products. P&G, under Lafley's first term as CEO, even set targets for failure, fearing that his executive team was becoming risk averse.

Most highly-innovative companies[12] which we have researched have a positive approach to failure as part and parcel of setting the appropriate climate for innovation. The challenge, especially for larger corporations, is not so much screening new ideas, as it is ensuring that ideas are generated and, for those that have merit, eventually reaching commercialization.

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[10] Wikipedia
[11] Agrium comment from their Annual and Special Meeting of Shareholders and Management Proxy Circular, May 7, 2014.
[12] For example; Procter & Gamble, GE, and John Deere

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Boards often interpret their role as one of assessment or control - akin to ensuring that the rules are followed and that, if they are, then all is well – with the added emphasis on endorsing ideas which come to their attention rather than making contributions to the process. This denies the benefit that could be derived from comments, cautions, or encouragements, which could come from knowledgeable Board members.

The CEO is considered the go-between the organization and those representing shareholders but information and knowledge about innovation usually stops short of the Board, if not, even below the CEO in some larger organizations. This leaves the Board unable to contribute to the innovation process and, more importantly, unaware about the innovation initiatives which are launched within the organization and which can involve risk far in excess of environmental matters.

Risk is the responsibility of the board but the ability to exercise this role is dependent upon having information which portrays the innovation initiatives of the organization; thus the notion of a 'template' and as organized process to bring forth relevant information.

Venture capital firms offer good examples of how to keep on top of, i.e. manage innovation, initiatives. Since the success of the VC firm is so much based on their relatively few significant investments, which need nourishment pre the inevitable IPO, VCs have evolved methodology for increasing the odds of success. Boards of larger firms could learn from their experience.

- VCs first of all know that a high percentage of innovation initiatives will end in failure.
- Innovation initiatives are represented by a mix of investments and interests among the management group – backed by the CEO – some with a higher risk profile than others.

The Board, obviously, should be aware of the riskiest of these initiatives, but the riskier projects should also be set in the context of innovation for the whole organization. Thus a Board's view of the portfolio of innovation initiatives provides the board with a view on the totality of risk and therefore they are better able to judge, on behalf of shareholders, how the organization thinks about, and acts upon, innovation initiatives.

With such information, the Board is in a much better position to advise the CEO about the rate of innovation in the organization and bring to the fore a more balanced perspective on all innovation initiatives.

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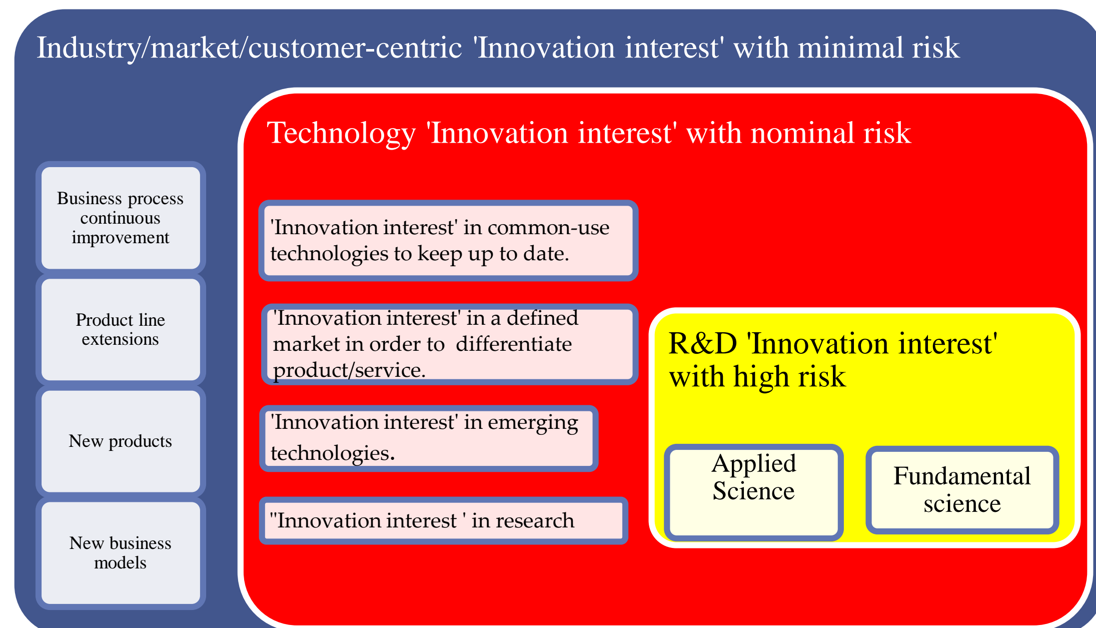
Many organizations have accelerator programs for innovation – which is good – but a Board should have a part to play in decisions regarding the use of accelerators as the implication is that the risk profile is about to be raised; clearly a Board responsibility.

The template sets out a range of innovation activities from the least risky to those innovations which could be disruptive and thus riskier.



The term ‘innovation interest’ is used to denote that not all innovation is represented by the use of capital, nor spending, nor labor but can be emotional and may at times simply be thoughts – or interests - which do not result, for many reasons, in actions or outcomes in terms of new products or services. ‘Interests’ can still absorb time and thought.

Articulating innovation; a first step

Most would agree that Innovation needs better definition but more importantly, within any one organization, their needs to be a common understanding regarding the scope and depth of the word. Sources abound, and it is not particularly the task of this white paper to choose amongst the best definitions.

Innovation incorporates all changes from the least risky – continuous improvement – through to experimenting with the most fundamental science typical of the work of universities and research institutions; i.e. the full spectrum of innovation including innovation changes in the supply chain! Supply chain innovation can be a highly disruptive technology.

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Each organization will have its own manner of describing innovation and its own take on the risk inherent in their own innovation activities. Risk is associated with all change.

What is critical is that the organization know the full range of innovation deriving from its activities and to be able to communicate these internally and in some form to the CEO and to the Board of Directors. Too little 'innovation' can signal a decline in the long-term survival of the organization but too much innovation raises the risk profile of the organization. The Board's decisions are directed to finding the balance point and it needs to understand the weighting to be placed on different aspects of innovation.

Of the companies or situations which we have researched, both the issue of the pace and depth of innovation has proven critical and in hindsight decisions might have gone differently if the Board had been involved.

For example; RIM, or Blackberry as the company is now known, while initially having the management practices and risk profile of a growing entrepreneurial firm, changed its stance when it came to keeping up with, and responding to, competition. It relied too heavily on the least risky source of innovation; satisfying direct customer requests for modifications, and in so doing lost sight of developments in the overall market, most particularly from Apple. RIM's risk profile went from top of the measure to the lowest. A strong Board might have made provided better input by seeking more information on not only on the competition, which would be obvious, but on what was happening inside RIM. Similarly, HP's innovation prowess was significantly impacted when, under Mark Hurd, it started to cut its R&D spending in order to maximize short-term profitability, little appreciating the longer-term implications for the culture and motivations of this once-favored innovative organization.

3M, according to Buckley, went too far in introducing Six Sigma under the regime of McNerney. Buckley was to later admit that the move almost killed the company[13]. The Board supported this initiative but one wonders by what measurements this decision was taken. A survey of 3M employees would have likely provided the Board with second thoughts.

An illustration of too much innovation is provided by the highly-innovative financial instruments associated with turmoil in the financial markets precipitating the crises of 2008 and beyond. J.P. Morgan's Board might well have had something to say about the new generation of products; credit default swaps and asset-backed securities had they been able to foresee the ensuing devastation resulting from, not just their new product concepts, but from the systemic changes from other participants; e.g. the ratings agencies.

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[13] See the review of 3M available at http://www.corporateinnovationonline.com for the source.

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Boards and CEOs often focus on problem areas particularly when there are deep issues to resolve. Problems have a way of monopolizing senior management's time. Conversely, if financial performance is better than expected, even outstanding, the tendency is to cast one's attention to other areas but it is precisely at this point that the innovation pipeline should be scrutinized and adjustments made with a longer term view.

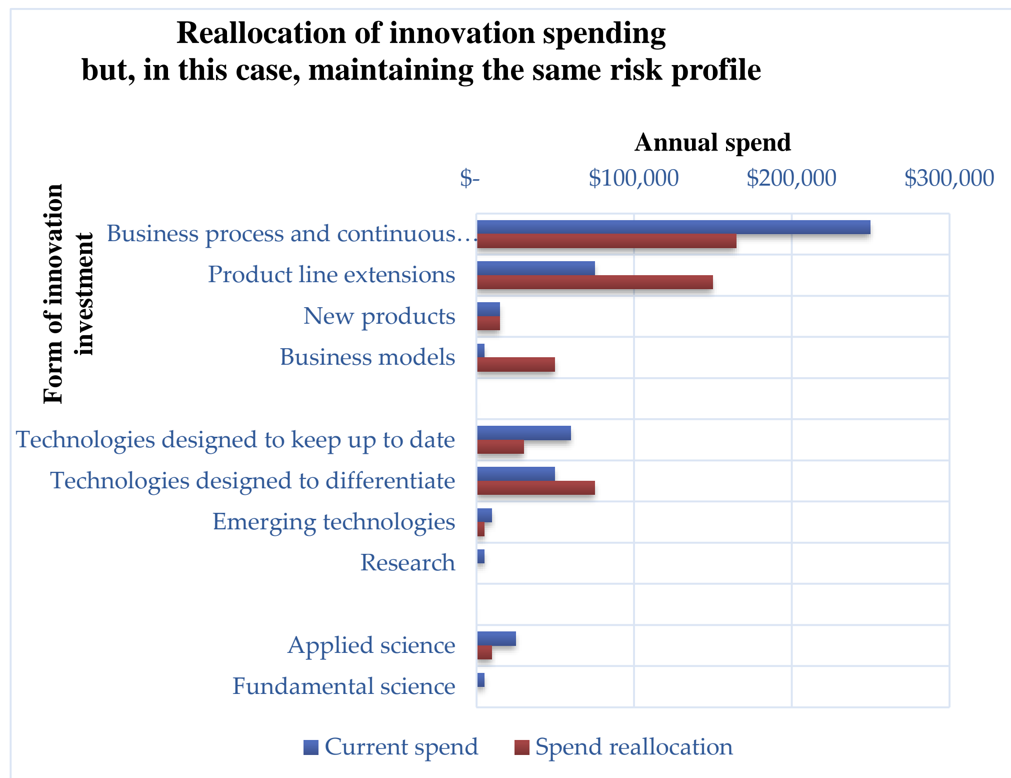
Articulating innovation is not easy but this should not be an impediment to meaningful Board involvement.

Measuring innovation risk – the metrics

Both inputs to innovation activities and results achieved from those activities require tracking by the Board.

While it may be difficult in many cases to measure each investment into innovation activities, there is an opportunity to note the change in emphasis over a given period of time. Boards should be made aware of a renewed emphasis by category of spending and be prepared to advise on the both the short and long term impact of a change in course.

In the simple example below, the differences in annual spending has shifted while the innovation risk profile has remained essentially the same.



- There has been a shift out of fundamental science but there is now an established link with a relevant research institution in its place.
- Applied science spending has been reduced for the same reason as for fundamental science.
- Spending on technologies designed to keep the organization up to date have been reduced in favor of increasing spending on technologies which could lead to a differentiation of product or service.

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- Investment in continuous improvement, product line extensions and a new business model have been increased marginally.

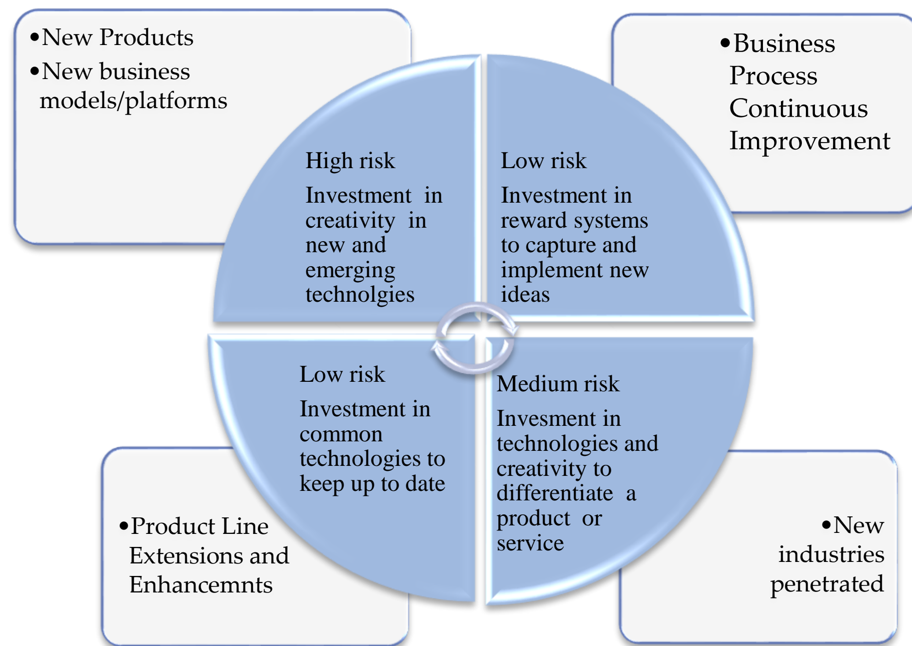
Of some obvious concern would be the investment in new products; remaining essentially the same on a year-to-year basis.

While inputs into the innovation process should be highlighted, it is the outcome of investments that also need to be tracked.

Common metric and non-metric measurements deriving from innovation initiatives are numerous and illustrated by the following chart. Innovation, as it is used in this paper, includes the full range of ideas which percolate within a company and must find a way to surface and be implemented. Ideas and change come with risk. The four quadrants suggest a range of low to high risk dependent upon the intended focus of the investment in technologies of one form or another. Investment, while usually thought of in monetary terms includes all resources: time, thought and even emotional energy.

New products and new platforms can be tracked by

- Patent applications
- Patents achieved
- Ability to hire SMETS personnel
- Number of 'breakthroughs'
- Rewards from external sources
- Publications in prestigious journals
- Licensing fees derived
- New products as a % of current offerings
- Dropping under- performing products



Business process improvement can be tracked by

- Reduction in cost per unit
- New technologies adopted
- Service levels improved
- New customers added in existing markets
- Revenue per employee
- Revenue per units of production
- Measurable quality improvements

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New industries penetrated can be tracked by

- Number of collaboration linkages
- Stakeholder (employees, suppliers, customers) surveys
- Results of 'exit' interviews with innovators
- Risk profile at target level

Product line extensions can be tracked by

- Ideas generated and in the pipe-line
- Ideas generated and implemented
- New markets entered

The appropriate measurements require development for each organization and for each industry.

Boards of Directors, supplied with this type of information are in a position to better understand the business, to raise insightful questions and be in a better position to offer a valued perspective

Other measures – requiring surveys or extensive analysis – offer a variety of ways of measuring innovativeness at least as seen by stakeholders, customers and even employees. Here are a few; some better than others.

- Surveys that provide customers opinion of your company's innovativeness and its brand image – as compared to the competition

- Financial analyst rankings and feedback from investor relations broadcasts to the media.

- Stakeholders' (in this case suppliers, investors, etc.) opinions on the 'innovativeness' of your company compared with their opinion of the competition

- New sales to new customers - marks the rate of new customer acquisition reflecting the efforts to enhance the brand.

- Measurements of incidence, or rate of increase, of attractive, internally generated investment opportunities (the size of the pipe line) which come under review by senior management and the Board.

- Increase in the value of intellectual property generated from internally-sourced ideas; augmented by acquisitions of IP from other organizations. The information could be broken out by IP for existing versus new product initiatives.

- Share price premium attributed to the company's reputation for innovativeness.

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- Conducting an analysis focused on employee retention and ease of attraction.
- Collaborations and partnerships reflecting the company's reputation for its innovativeness
- The percentage-of- time key executives/Board members spend on innovation as a specific topic of a meeting, seminar or workshop.

Phil McKinney[14] perhaps summed up the situation when he stated:

If you set the right metrics, then you're going to have people doing the right actions. Consistency in producing and measuring the innovation metrics will eventually take hold. It eventually will become part of the corporate culture, but you can't give up. Because people work to metrics.

[14] Phil McKinney.com

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Appendix A
Innovation Pipeline
5 Steps for Building an Innovation Pipeline

BY KARL STARK AND BILL STEWART who are managing directors and co-founders of Avondale, a strategic advisory firm focused on growing companies. Avondale, based in Chicago, is a high-growth company itself and is a two-time Inc. 500 honoree along with a highly-interesting follow-on comment from Jeffery Phillips.

If your business has problems turning ideas into business growth, you may need to create an internal team charged with bringing new products to new markets.

One of our clients recently expressed her frustration that she and others in the organization were generating a lot of ideas for new products and markets, but she had no team she could rely on to run with the ball and turn those ideas into real (and profitable) revenue. We worked with her to design an internal innovation team charged with assessing and prioritizing new opportunities. Forming the team requires us to address three key questions:

- Is there truly a need for innovation in the business?
- Is innovation a key value driver?
- What skills do we need on the team to achieve our innovation goals?

Need for Innovation

Innovation is a key driver of profitable growth. Commoditization and me-too competition is a constant threat to our clients, who must be distinctive in the marketplace to create value for their investors.

Nevertheless, we can always supplement our bias toward innovation with cold hard facts.

Three common innovation issues we encounter are:

- The bulk of sales derive from products that are more than three years old. This typically shows that the business is not being innovative.
- New products are introduced, but fall flat in the marketplace. This indicates that the business is being innovative, but execution is broken. Maybe the sales team is unable to sell what the product developers have produced. Maybe the products are flawed in fundamental ways.
- New products are introduced and sell quickly, but at lower profit levels than existing products. In the early days of a new product introduction, low profits may be natural and expected. However, if the new product profit margins do not improve as sales increase, the innovation process may be broken--because it's cannibalizing existing products with nothing to show for it.

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In our client's case, their primary challenge was issue No. 1. They were simply not introducing many new products and did not have a robust innovation pipeline. To bulk up their innovation team, we needed to establish five key stages of their innovation process:

1. Concept Validation
Validate the product concepts that have been generated, assess and quickly determine if the concept merits further consideration.

2. Business Case
Define the product specifications in the form of a business case that shows positive ROI from the investment required to bring the product to market.

3. Development and Implementation
Develop the product with involvement from the product development, process/systems, and marketing and distribution teams.

4. Launch
Achieve "day one readiness" so that all distribution channels would be ready to support the new products.

5. Post-launch Tracking
Assess project effectiveness and efficiency and measure revenue, profitability and ability to meet customer needs on an ongoing basis.

Each of these stages requires different skills. For the early stages, market research and financial analysts are needed. For the middle stages, we need product managers and project managers who can push the product to launch in a timely fashion. Post-launch tracking requires project management skills as well, to take in learnings and execute the inevitable follow-on improvements based on those learnings.

All told, we needed to staff up 10-12 people with a mix of research/analytics, project management, product management and channel development skills. This team has to be very entrepreneurial and tenacious to drive successful product launches. The client is hiring this team now, which we believe will lay the groundwork for an aggressive effort and a robust innovation pipeline.

LAST UPDATED: AUG 14, 2012
WEDNESDAY, AUGUST 23, 2006
Innovation Pipeline *posted by Jeffrey Phillips at 2:16 PM*
What do you think would happen to a sales executive in a large organization who was asked about his pipeline and could not produce one? As we all know, sales management is constantly hounding the sales team for up to date sales projections. A typical salesperson spends at least an hour a day updating his or her sales pipeline, noting the opportunities being pursued, the size and scope of the opportunity and the likelihood of winning the deal. Various levels of sales management receive these updates, apply "judgment" to the reporting and consolidate the report into a final pipeline.

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A good sales manager knows what deals will happen next week, next month and next quarter. Every large organization has some form of sales reporting and pipeline management. Otherwise, they'd be driving blind, going into the future without a good sense of near term potential revenue.

Contrast that with the state of innovation today. There are teams and individuals working on new ideas which may become new products or services. Unlike the sales teams, these innovation teams do not have an integrated management structure, don't report to the same people and don't generally have any incentive to report their status or prospects. Additionally, they don't share a common methodology or philosophy, naming convention or set of reporting tools to collect and report their status. In fact, many of these teams seek to keep their work secret (skunkworks to keep it from being influenced or killed by management or other teams.

So, in many "innovative" firms it is difficult if not impossible to get any sense of an innovation pipeline similar to a sales pipeline. Want to know what ideas people are currently working on that might become that new product in six months? Go ask each team, if they'll tell you. What's the potential return on the innovation investment for a particular idea? What measurement should the team use in order to report that? How likely is an idea to become a valuable new product or service? What are the odds of a successful launch and winning in the marketplace? Whose definitions should we use?

Too often, ideas are wrangled through disparate systems and processes by idea champions who quite literally pick up the flag and carry it through the muck and push and cajole and beg until their idea is considered and moved forward. If you are lucky enough to identify these people and have them report consistently to you, then you might be able to create a reasonable picture of your innovation pipeline. Otherwise, trying to find the ideas and teams and trying to apply judgment to the ideas to determine the value of your innovation pipeline and its potential timing is close to impossible.
Why should this be? If innovation - defined as bringing a new idea to market as a valuable product or service - is the driving force for new organic growth, and if innovation is a top three priority for most businesses, certainly we'd want to know where the investment is going and what the likely return is on that investment, and the relevant timeframes. If the sales teams can create a reasonable, quantifiable sales pipeline that is used by industry analysts and Wall Street experts to judge the financial wellbeing of the company, certainly any firm that prides itself and differentiates itself on innovation should be able to create an innovation pipeline.

What's standing in the way? A lack of enterprise systems to capture the ideas, a lack of corporate standards to judge the ideas according to their viability and potential return, rosy scenarios about the length of time it will take for the idea to blossom and the real cost of bringing the new product or service to market. Sales guys figured out a long time ago how to quantify their opportunities, and sales management applies the relevant judgment on those reports to create a viable pipeline. Innovation managers need to create their own standards and begin reporting the likely return on innovation and the timeframes or they won't be taken seriously for very long.

Sales management benefits from the fact that all sales people belong to and report to the same business function, and are compensated not only for closing deals but for reporting their progress

and pipeline. Obviously the sales team has an easier job capturing and managing the information, but that does not excuse the fact that the important innovative ideas that will drive future growth are not well managed or reported today.

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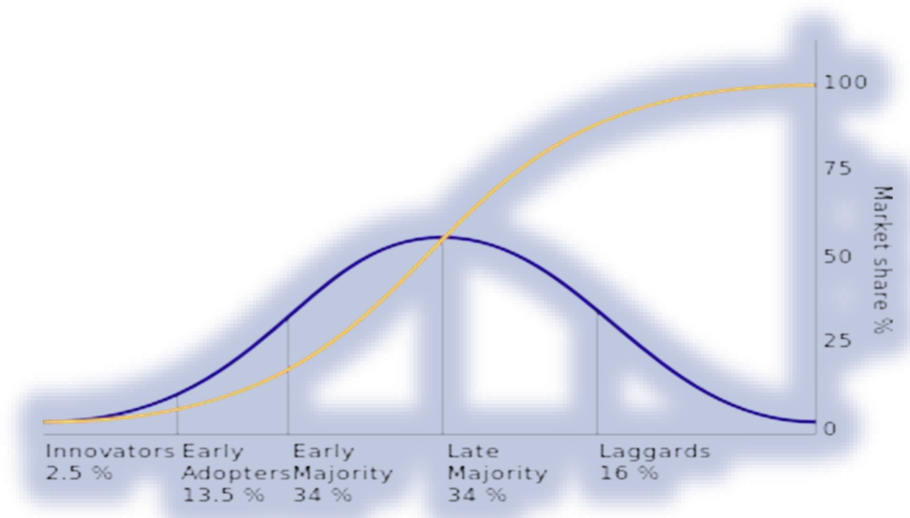
Appendix B.
Innovation Curve[15] and the Board's Role

The innovation curve has proven to be a useful method of characterizing the growth and decline of ideas. At each step of the process, the Board has a role to play often as a shared responsibility with the CEO.

Ensuring that all appropriate enabling mechanisms for encouraging innovation are in place, such as;

- Dedicated organizational units
- Strategic alliances
- Management practices



Corporate governance of innovation by way of;

- An outside advisory group
- Special Board-level committee
- Appointment of an innovation czar

Stimulating the search for ideas by;

- Providing vision
- Encouraging idea generation
- Ensure there is a process in place for searching for new products
- Articulating attitude to risk

Providing the appropriate incubators for new ideas;

- Committing resources
- Ensuring that the organizational structure is conducive to innovation by empowering champions; technical, business and executive appointments

Ensuring that reward mechanisms for innovators are in place;

- Provide special incentives for innovators
- Ensure that the Board-level compensation committee notes special attention to innovation incentives and to remove disincentives.

[15] Curve courtesy of https://www.google.ca/search