ISSUE 168

Freedom to Fail: Risk Appetite for Innovation

The manner that failure is embraced instead of feared in a business can improve the way the company evolves and responds to new market opportunities. How should the proper tone for innovation be set in a business? What is the board's role in empowering people to fail?

At a recent National Association of Corporate Directors (NACD) Master Class event,[1] Protiviti moderated a discussion among the participating directors about making innovation work in today's rapidly evolving and disruptive markets. The premise underpinning the conversation was that the risk-reward balance of years past with respect to innovation may not be suitable in the years to come.

The big picture is one of constant change fostered by disruptive technologies — generative artificial intelligence, the metaverse, digital twin solutions, quantum computing, the ever-expanding Internet of Things, and increasing broadband speed and access. The effect of technical debt and the likelihood of waves of regulation to protect consumers from harm and avoid unwanted consequences are also relevant considerations.

- This picture of continuous, dramatic change offers opportunities for innovative companies to place smart, data-informed bets.
- It also poses a lethal inflection point for companies embracing the status quo.

[1] NACD Master Class in Orlando, Fla., May 11, 2023.

Strategic agility — the ability to improve performance and thrive amid disruption — has emerged as a critical success factor in sustaining relevance. This makes innovation the organization's lifeblood. But the real question is why are some organizations more successful at innovating than others? For example:

- Why do some companies have a higher percentage of revenue from products and services introduced to the market over the last two or three years than others?
- Why are some able to be disruptive in the marketplace while others appear to embrace status quo thinking?
- What's the secret sauce? Is it corporate culture? Is it about talent and how people are incentivized? Is it the data that more successful companies collect from customers?
- How does risk fit into the conversation? How do more successful companies balance innovation initiatives with the legacy business?

Strategic agility is about sustaining alignment with changing business realities, including reinvented business models, redesigned workflows, and new and improved market offerings.

Position the Organization to Pivot Quickly

These are important questions for directors. In the digital age, the board has an important role to play in strengthening and nurturing the innovation culture. To that end, the NACD Master Class discussion offered a useful road map for directors to consider.

Position the organization to pivot quickly — with resources, leadership and capital allocations.

Strategic agility is about sustaining alignment with changing business realities, including reinvented business models, redesigned workflows, and new and improved market offerings. The recent global pandemic experience may be in the rearview mirror, but it provided an object lesson that organizations can innovate with intention more rapidly than they ever thought they could.

For most companies, it was a matter of innovating out of necessity using capabilities that had been available for years to create room to maneuver in the face of an abrupt, massive shift in market conditions. What did it take for companies to implement sweeping changes to their processes and market offerings in a matter of days? Attention to changing markets, an ability to adapt, proximity to customers, decisiveness in the face of uncertainty, a commitment to act to address new realities and a resilient workforce come to mind.

These same attributes offer keys to driving innovation at market speed both now and in the future. Risk planning and resilience planning go hand in hand to identify blind spots, maximize preparedness and encourage out-of-the-box thinking. Some ideas:

- Have top performers or outsiders think about the confluence of potential market conditions, possible competitor actions and disruptive technologies that could take down the company, and present the results to the executive team and board.
- Identify the toughest challenges in executing the strategy and consider how to address them.
- Identify the company's most critical enterprise assets and their most significant threats, and discuss how to enhance and preserve their value.
- Conduct a periodic risk map analysis (e.g., evaluate "what if" scenarios, capture and synthesize the learnings, and incorporate them into the strategy-setting process).

Apply an "Outside Looking In" Approach

Innovation strategy cannot be formulated in a vacuum. The organization should avail itself of external perspectives.

Apply an "outside looking in" approach. For example:

- Connect innovation to customer value through a focused effort to blend customer experience data, institutional knowledge and digital perspectives when making decisions on how best to channel emerging tech initiatives to improve the customer experience continuously.
- Involve customer advisory teams, a "chief customer officer," knowledgeable subject matter experts and field operators at the innovation "drawing table" and encourage them to challenge assumptions and point out blind spots.
- Meet periodically with and learn from investment bankers to discuss innovation ideas as they monitor and study industry developments.
- When evaluating strategies to monetize the company's intellectual property, pay attention to how startups are being funded (i.e., how are they framing their value proposition with investors to attract funding partners?).
- Obtain innovation ideas from external sources such as academics, startups, software and consulting companies, industry and technology trends, and innovation communities, suppliers, and external partners who are part of the value ecosystem.[2]

Learnings from the "outside looking in" should be condensed into easily digestible business intelligence for decision-makers.

[2] "8 External Sources of Innovation," by Sophia Hübner, Itonics, May 23, 2023: www.itonics-innovation.com/blog/8-external-innovation-sources-you-should-know.

Understand the Appetite for Risk

Reach a common understanding of innovation risk tolerance and risk appetite. The board is responsible for the preservation, safety and growth of economic value. When focusing on innovation strategy and initiatives, risk appetite is not just about the maximum risk to take but also the minimum innovation fail rate. This means mitigating risk-averse behavior. The notion is, “If you’re not failing, you’re not learning.”

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- The board should engage in continuous conversations about the kinds of innovations the company needs, including innovations pertaining to the business model, business processes, and product and service offerings.
- This conversation should be fed by what the company is learning about markets, customers, consumers, competition, suppliers and regulators.
- The conversation should address the innovation budget (e.g., how much to invest, where to invest and why).
- It should also cover incentives to ensure people are empowered and rewarded even if they fail.

The bottom line: Periodically, the board and management should consider whether the company is taking on enough innovation risk. How much risk is enough? Are our incentives right? Do we have the data we need? Is the fail rate too low or are we failing too slowly? Is there evidence we are penalizing failure?

Focus on the Desired Results

Focus on the expected innovation results. The board should engage management in setting innovation policy and facilitating risk-taking. Excessive processes and controls can stop innovation in its tracks (i.e., “corporate oxygen” can suffocate a startup).

While some guardrails are needed, it is up to the board and CEO to find the balance and frame the culture that allows the freedom to run. Focusing on customers is vital:

- What’s working?
- What’s not working?
- What are competitors doing?

Market intelligence centered on the customer experience can facilitate decisions on where to be a disruptor to avoid being disrupted.

Why it matters: In today's digital world, it's easy to recognize the power of technology in driving continuous improvement in processes, products and services as well as creating a disruptive force to reinvent business models. But technological underpinnings are not always needed for innovation to be transformative in strengthening brands and leapfrogging competitors. For example:

- Roberto Goizueta transformed the Coca-Cola Company by divesting side businesses and focusing solely on the soft drink business, consolidating the bottling network and introducing new products that became highly popular.
- Shareholder value increased over 35 times during Goizueta's 16-year tenure as CEO, and the brand became more international — arguably the most recognized in the world.
- Airbnb and Uber are recent examples of business model innovation.

Between the lines: As innovation can also focus on continuously improving processes, products and services, it helps to view it as a discipline that enables the organization to play defense better or offense differently.

Make the Innovation Process Fit for Purpose in the Digital Age

For organizations that have made innovation a priority, the traditional process has featured a number of attributes. The process designated responsible individuals, set performance expectations linked to company objectives, allowed them to operate in a risk-free environment, monitored progress using appropriate metrics and held them accountable for results.

Yes, but: For many organizations, innovation has been opportunistic and ad hoc. There is no off-the-shelf process design to enable innovation to reach its full potential in the digital age. Nonetheless, innovation is and will continue to be a differentiating skill.

Several years ago, a well-known former CEO issued a letter to shareholders[3] offering sage advice on fostering an innovation process:

- **Protect a company's vitality with a true customer obsession:** This means experimenting patiently, accepting failures, planting seeds, protecting saplings and doubling down on customer delight. A strong, data-informed focus on the customer experience ensures the relevance of innovation.

[3] "Jeff Bezos on Why It's Always Day 1 at Amazon," by Amazon staff, Amazon News, April 17, 2017: www.aboutamazon.com/news/company-news/2016-letter-to-shareholders.

- **Do not allow proxies to displace a deep understanding of the customer:** Effective processes enable serving customers. But management needs to ensure that the process doesn't become the thing — which can happen easily in large organizations.
- **Embrace external trends to seize a tailwind:** The outside world can threaten a company that won't or can't embrace powerful trends quickly. Fighting these trends — whether they relate to changes in the industry, demographics, customer preferences or geopolitical realities — is tantamount to fighting the future.
- **Emphasize high-velocity decision-making:** This is easy for startups but challenging for large incumbents. Speed matters in business. Avoid a one-size-fits-all decision-making process. Make decisions with somewhere around 70% of the information desired, rather than waiting until obtaining 90% or more. Be good at course-correcting bad decisions so that being wrong is less costly than being too slow.
- **Pay attention to organizational alignment:** Recognize true misalignment issues early and escalate them immediately to the right people.

In summary: While no one has exclusive ownership of the "secret sauce," organizations should give careful thought to the above fundamentals to make their innovation impactful on a continuous basis.

Make Innovation a Data-Driven Core Competency

The board should understand how management is nurturing and strengthening the internal capabilities conducive to an innovative culture and measuring and rewarding innovation so that it becomes a core competency.

- The board's focus should embrace priority-setting, capital allocation, talent acquisition, leadership development and top-line growth.
- An innovation core competency starts with data for decision-making.
- The phrases "data-informed" and "data-driven" do not mean relying on the data available. The focus should be on the data necessary for making decisions. This may be one reason there is an emergence of the chief data officer in the marketplace.

The board should ensure that the necessary data and information are available to support the innovation process without sacrificing decision-making velocity.

The bottom line: The board should ensure that the necessary data and information are available to support the innovation process without sacrificing decision-making velocity.

What you should know: Companies should sharpen their line of sight on innovation priorities by mapping their 10 best opportunities for experimentation, and they should keep the map current. Managers responsible for innovation initiatives should be evaluated based on their respective portfolio of outcomes rather than single projects. A dashboard reporting the results the innovation strategy is delivering, return on investment, and the effectiveness of the company's research and development processes supports boardroom discussions regarding progress and accountabilities.

In a slowing economy, an emphasis on cost-cutting cannot lead management to lose focus on innovation strategy. The marginal analysis supporting capital allocation to innovation investments in order to generate value remains relevant.

Pay Attention to These Two Points

Fail fast to learn quickly. A higher innovation risk appetite can increase speed, provided there is a strong focus on failing fast and learning quickly. This reduces project risk by minimizing the time and resources invested in unsuccessful initiatives.

A key point: It is smart to break down large initiatives into discrete manageable segments that can be evaluated quickly to learn what works and what doesn't so that the larger initiative can progress more rapidly with confidence. The notion of failing fast should enable innovation teams to redirect efforts toward more promising solutions.

Organize the board for innovation excellence. The board should set the tone and culture for innovation. To that end, directors need to be adept at strategic thinking, abreast of the evolving technology landscape, and cognizant of how emerging technologies can impact the customer experience and the company's talent acquisition and retention strategies.

The key is to understand changing business realities, often expressed as having "currency." Though not easy to sustain, currency is a board prerequisite to engaging management effectively in strategic innovation conversations.

Board composition is also important. For example, an analysis of the boards of U.S.-listed companies determined that companies with boards of directors that have at least three technology-savvy members outperform other companies.[4] But the importance of the innovation discussion is such that every director should be engaged.

Yes, but: Too often, most people in the boardroom are not involved in the innovation strategy discussion.

[4] "Without a Digitally Savvy Board, Your Company Is Falling Behind," by Peter Weill and Stephanie Woerner, The Hill, March 20, 2019: https://thehill.com/opinion/finance/434788-without-a-digitally-savvy-board-your-company-is-falling-behind.

In Summary

Taking calculated risks in an intelligent and proactive way to drive innovation and sustain competitiveness is necessary to thrive in a rapidly changing world. Innovation inherently involves uncertainty. Accordingly, not all endeavors will yield desired outcomes.

Framing risk appetite for innovation is about unleashing creativity and accepting failure as a natural part of the process. The focus is on the upside of unlocking untapped potential, identifying new revenue streams, improving operational efficiency and enhancing the customer experience. That is why board leadership on the innovation front is as important as company leadership.

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- Protiviti, in partnership with Broadridge and BoardProspects, invites you to contribute your insights to our Global Board Governance Survey. This survey aims to identify opportunities for improving boardroom performance by analyzing key differences in viewpoints between directors and the C-suite regarding the board's effectiveness. Take the survey today.

How Protiviti Can Help

Protiviti helps organizations think digital-first. From digital strategy and business innovation to solutions and services across marketing, sales and customer success, we help companies redefine how they reach and engage customers and innovate business models. We assist with creating digital products and channels and deploying data to uncover and connect insights critical for decision-making and enabling operations. We help companies orchestrate the skills and agility required to unlock growth and compete in today's marketplace.

We partner with companies to drive profitable growth at the nexus of human-centered digital connections and enterprise operational change. Approaching every engagement with the vision of a startup founder, the precision of a watchmaker, the collaboration of a trusted adviser and the creativity of an artist, our focus is on orchestrating at the intersection of strategy, design, technology and assurance. We also use human-centered design and strategies to stay rooted in purpose, while elevating experiences past the point of simple utility to create lasting relationships and loyalty. Our approach is grounded in empathy for understanding and agile thinking for rapid action and a focus on those the company serves. We partner with best-in-class technologies to bring leading thinking and capabilities to our clients.

About the Authors

Frank Kurre

Managing Director, Protiviti

Frank Kurre works with our firm's clients and account teams in leading Protiviti's global board governance, CEO and alumni programs. Based in New York, he is focused on expanding Protiviti's deep relationships globally and working with Protiviti's CEO and other senior leaders on projects of strategic importance to the firm.

Contact Frank at frank.l.kurre@protiviti.com.

Jim DeLoach

Managing Director, Protiviti

Jim DeLoach is a founding managing director at Protiviti. Based in Houston, he is well known for his commentary on many governance topics.

Contact Jim at jim.deloach@protiviti.com.

Protiviti partners with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on https://blog.nacdonline.org/authors/42/. Twice per year, the six most recent issues of *Board Perspectives* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.

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