



EY Center for Board Matters

Four ways boards are driving innovation in a volatile environment



Uncertainty and volatility continue to shape the (almost) post-pandemic world. While the last two years may have forced many companies to innovate more quickly and in ways they could not have imagined, how they will move forward remains a question.

How boards can help companies capitalize and thrive on innovative pursuits has been a priority topic in our ongoing discussions with CEOs and directors. It is clear that directors are more engaged than ever in these strategic discussions,

and they are asking questions that go deeper than in the past. In this article, we present key insights and takeaways from these discussions.

In brief

- ▶ Boards are becoming more engaged with their company's innovation journey and can provide important oversight and support along the way.
- ▶ It is important for boards to acknowledge where the company is now, seek outside views and understand trends to help determine how to innovate for the future.
- ▶ When obstacles to innovation arise, boards can take steps to guide the company around these challenges and stay focused on the ultimate destination.

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DETERMINING THE DESTINATION

Where does our company need to go?

Any successful road trip begins with anticipating the future. It's about setting a destination and deciding where to go. Usually, this means thinking about the possibilities of places you've never been, exploring the options, and perhaps reading blogs, guidebooks and reviews to understand what others have seen and recommend.

For a company journey, broad input is critical to defining the future path. In practical terms, this means adding a “future-back and outside-in” analysis, where input comes from outside the ecosystem rather than the regulars at the corporate table. The board can play a key role in leveraging their skills and outside perspectives plus sharing of best practices from other companies with which they engage; often they are not asked. Defining the future and the innovation that will be needed to get there should include looking at external drivers and megatrends that point the way, including societal, industrial, technology, regulatory and political elements. This is particularly worth emphasizing at a time when stakeholder expectations and demands are changing dramatically in light of environmental, social and governance (ESG) developments and other drivers. The environmental and social impact of a company's products and services have the potential to drive new market needs, and the companies able to anticipate what their stakeholders

need and innovate to meet those needs will be the leaders. Not surprisingly, directors and CEOs tell us that it is important to incorporate innovation perspectives from the following stakeholders into strategy-setting sessions.

- ▶ **External partners and customers.** Leaders of key customers, channel partners or suppliers; executives from companies that have a similar business model but operate in different industries or sectors; futurists, advisors and consultants who are already working on projects at the company and can provide insight into what they are seeing elsewhere. Management and the board can also have a third party conduct a “voice of the customer” session and interview customers to bring their perspective directly into the meeting.

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The innovation journey

For leading companies and boards, innovation is a journey rather than a moment in time. Therefore, the metaphor of a road trip is an apt one. Just as with any road trip, travelers must decide where they want to go, map the path from where they are to their destination, make adjustments to roadblocks along the way and ensure successful arrival. Since the most memorable road trips inevitably involve surprises and perhaps even alternative destinations, being open to new experiences is also essential.

- ▶ **Internal stakeholders.** Employees via surveys or direct interviews on innovation driver topics; having next level down from C-suite present at annual board retreats; and employees working on specific future-oriented projects who can share the research and trends they are seeing.
- ▶ **Investors/analysts.** Institutional investor representatives and industry analysts who can provide a broader voice of the marketplace and share how they analyze what other companies are doing and how they think about innovation and long-term value. Investor relations teams can also bring in survey data and the issues they hear in the course of their conversations. Tracking where venture capital investments and the startup ecosystem are headed is another source of understanding potential futures.
- ▶ **Supply chain partners.** With ever-increasing challenges in operations, having direct insight to various partners across the supply chain ecosystem is key. Now with vast quantities of data and analysis, information and insight can be brought in from supply chain players and multiple levels of the ecosystem.

Along with these outside perspectives, board members bring their own external insights drawn from their experiences, knowledge and involvement with other companies.

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To encourage that input, more CEOs are having pre-meeting conversations with individual directors to understand their point of view and confirm they share the insights during board meetings. Setting the discussions in a learning environment can also be useful, such as holding board meetings in industry conference locations to encourage board members to hear what is happening for themselves.

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STARTING WHERE YOU ARE

What is the current state of innovation at the company?

Before setting out on any journey to a destination, knowing the starting point is essential. Just as the first thing we do is look at the GPS marker to orient to our current location before we start driving, boards need to understand where the company is now – the current state inside and outside. With COVID-19 prompting new ways of operating, boards and management teams must reassess to understand the changes already underway. Aspects garnering attention in board discussions included the following.

- ▶ **Taking an innovation inventory.** Directors and CEOs tell us that certain innovations in terms of automation and processes that were already on the strategic map were accelerated, while other changes and new approaches have grown out of creativity while operating in the virtual environment of the pandemic. Doing an innovation portfolio review, looking at what is being done differently across the whole organization, and putting this in the context of the company's innovation track record can highlight what new competencies have been developed that are now part of the company. Several directors we talked to noted the importance of documenting the lessons learned over the past two years to create full visibility into the current state of innovation.
- ▶ **Leveraging pandemic changes.** "Companies were able to respond to the pandemic in ways they never thought possible, which allowed them to see themselves and opportunities differently," according to one director we heard from. For example, in a virtual environment, the challenge of building scale might look different. Another director pointed out that supporting customers with cashflow issues, communicating with regulators, and changing workflows while many employees were working remotely has meant "building an ecosystem overnight." This has been particularly true for highly regulated industries where communication with regulators has become more flexible.
- ▶ **Redefining competitors.** The definition of competitor has become more fluid, with companies selling products at their competitor's locations or suppliers now serving consumers

directly, for example, a national grocer launching a warehouse-to-consumer delivery business model. As one CEO described this approach, "It is now about threats rather than competitors; it's how to build a heat shield."

- ▶ **Revising the supply chain.** A few directors and CEOs pointed to supply chain as "the most dynamic area of business [today]." With freight storage costs escalating, and container backups in major ports, sourcing from Asia has proved problematic beyond the challenges of disruption in supply chains. Directors and CEOs told us that the prioritization of onshoring initiatives to protect from future disruptions is important. Perhaps just as significantly, one director pointed out, "ESG goal-setting is helping (us) rethink supply chain." For example, climate change disruption is being built into operational expectations for key ports for the petrochemical industry.

Across all industries, the business ecosystem and how parties communicate changed at a pace few anticipated, but many agree is ultimately for the better. Notably, examples from the highly regulated health care industry include outreach among competitors and from regulators to enable more timely understanding of rapidly changing circumstances. Helping boards see the current landscape and state of innovation by systematically connecting them with the external ecosystem is a practice worth considering.

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DETERMINING THE ITINERARY

How should the board oversee the innovation journey?

Once the destination and starting points are determined, an itinerary is needed to provide guidance along the way. When the journey is on the road to innovation, boards are spending more time and consideration to support the CEO and their team. Leading directors and CEOs shared the following leading practices along the journey.

- ▶ **Challenging management productively.** It is natural to fall into the mindset of operating as usual, which is why boards sometimes need to question management teams on basic assumptions. For example, we heard that it is important to ask management why they might be pushing to get employees back into the office and whether they are considering real estate costs, carbon emissions and opportunities for automation. Directors also said they are asking how the company could deliver core services virtually, such as virtual tours for real estate companies – an approach that previously would not have been considered effective. Another avenue for board discussions is to seek clarity about “what were the other options [considered by management]? What was left on the table? Why?”
- ▶ **Balancing risks and innovation.** Working with management to clearly lay out risk appetite and provide guardrails for executive decisions is an essential part of the conversation, and one where many boards may operate at too high a level. As one director told us, the focus for boards must be “what are the risks associated with innovation and how do you balance that with potential reward?” Asking questions about what innovation options management chose not to pursue, as noted above, can also expose the risk profile and make clear what items had the next level of returns on investment or were considered too risky. On the flip side, a few directors noted that if there is nothing worrying the management team about a particular strategy, that may mean it is not innovative enough.
- ▶ **Taking a portfolio approach.** Another approach is managing to a portfolio of innovation and risk where there are explicit groups of strategic initiatives that are known to have high risk

of failure or a need to pivot but jointly are recognized and discussed by management. The board can then create an environment of support for contemplated risks while keeping the core of the business focused on tighter accountability to pure results with more certain outcomes.

- ▶ **Setting the tone at the top.** How the board provides oversight must also be considered and deliberate. Directors are focused on the importance of setting the right tone to foster a culture of innovation. One leading director urged colleagues to “introduce failure to the boardroom [because] part of innovating is failing, doing something that has never been done before.” Another said, “Set expectations at the board that it is ok to experiment and fail, but learn and iterate.”

In terms of how board members can best provide oversight, examples shared included having a continuous learning mindset as a director and seeking new sources of information to “keep track of macro trends that help you see around the corner.” The need for all board members to become familiar with emerging issues in operations, supply chain, digital and technology enablement, cybersecurity and ESG was emphasized by several directors we talked to. Naturally, the corollary is the need for the right overall skill set and diversity in thinking for the board itself. The need to assess skills and thinking to identify gaps in knowledge and cognitive diversity is clearly on the to-do list for leading boards.

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ENSURING SUCCESSFUL ARRIVAL

How do we keep track and stay flexible along the way?

As with any car trip, there may be detours and traffic jams along the way of the innovation journey. And we may reach the destination only to find we may want to slightly adjust the plans now that we see the destination. Just as we make sure we are reading the road signs and monitoring overall progress toward our destination, boards are called upon to provide the oversight and reminders about where the company is ultimately headed. Aspects for board consideration included the following.

- ▶ **Tracking and reporting.** With strategies and implementation becoming more agile, boards can help management teams track and report what is being done and document when changes and adjustments are made. As the strategic initiatives are launched in the market, tracking customer response, competitive actions and market shifts should be monitored to see if the assumptions about the future are playing out as expected or perhaps have moved. Interestingly, some directors told us that sometimes a management team can have a strategic pivot without having fully considered the reasons why a particular approach may not be working. This is where the boards can play a role in helping management pause and do an analysis. Also, by having management keep an ongoing list of agreed-upon strategic innovations and funding, board members can ask questions and periodically check in on the items and responsible individuals.
- ▶ **Keeping innovation visible.** The board is uniquely placed to model innovation and collaborative behavior. For example, board visits to laboratories and centers of innovation can offer a firsthand look at how advancements are being made. Another way to build visibility is to visit customers or other companies in the ecosystem to garner different perspectives.

- ▶ **Leveraging M&A, joint ventures and partnerships.**

For some companies, the journey to innovation includes adding capabilities through a significant transaction or alignment. We heard consensus among directors and CEOs about the importance of discipline and recording the thesis, budget and plan, and then revisiting and tracking it to learn what is working and what is not. For companies where post-acquisition analysis is built in, applying the same approach to innovation investments can be useful. With the competitive landscape being redefined, working and partnering with other parties can also accelerate the journey.

The practices shared above also play a role in enabling a culture of innovation that is linked to strategic goals. What metrics for innovation are reported to the board also brings up the question of how the board can consider incorporating these goals to the compensation of key executives, including the CEO.

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Boards are helping companies prepare for a successful innovation journey

Innovating to enable future growth in this uncertain business environment is a priority on the crowded board agenda. Without it, companies simply will not be able to deliver sufficient value to stakeholders who are redefining the stakes with an eye on long-term issues such as ESG.

Leading boards are guiding management teams and overseeing that innovation journey by defining where the company wants to go, understanding its current position, setting the tone and expectations, and reading the signs along the way.

While these activities are likely to prove challenging at times, no journey worth taking has ever been easy.

Questions for the board to consider

- ▶ How will the innovation strategy and roadmap contribute to successfully achieving the strategic plan, mission and goals?
- ▶ How does the board bring in external parties to provide a “future-back” and “outside-in” perspective?
- ▶ How is your board thinking about and redefining competitors or industry boundaries? Who might now be a competitor that wasn't previously?
- ▶ How are responses to COVID-19, supply chain and ESG challenges leading management teams to innovate?
- ▶ How are major investments reviewed by the board? What are the triggers?
- ▶ How are investments in innovation tracked and reported to the board?
- ▶ How does the board help ensure management's processes are flexible and adaptable to be able to incorporate lessons learned along the way?
- ▶ How does the board allocate capital allocation between existing and future business?
- ▶ How is the board engaged in innovation discussions as part of strategy-setting process?
- ▶ How are board strategy reviews handled? What is different today vs. a few years ago?
- ▶ If money were not a constraint, which game-changing innovation would management pursue?
- ▶ What do our employees and management team people think is our distinct capability? Where should we innovate more aggressively?
- ▶ What innovation is happening out there that we're not paying enough attention to? What do we do if a major online-only provider comes into our space?

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