IoD CENTRE FOR CORPORATE GOVERNANCE

# Public Inquiry: Governance and Innovation

## Call for evidence

June 2022

# About this inquiry

Innovation has long been recognised as essential for value creation, both for individual companies and for the UK economy as a whole. The development of new ideas, processes and technologies and their diffusion across different sectors is a significant driver of economic growth and productivity.

More recently, innovation has been identified as crucial to the transition of the economy away from fossil fuels and carbon-intensive business activities. There is a pressing need to develop new and adapt existing products, services and business models. However if we are to meet targets such as Net Zero we cannot rely purely on a relatively small number of highly innovative companies. All companies need to identify ways to 'work smarter'.

There are many different factors that affect whether and how organisations innovate, for example the availability of skills and capital and the public policy measures such as tax incentives. Arguably none are more important that the company's own culture, capabilities and internal systems – all of which are aspects of its governance. Unless companies are governed in a way that is conducive to innovation, they are unlikely to be in a position to take advantage of new opportunities.

Even if external factors and challenges such as global economic conditions mean companies may be unable to invest significantly in innovation at any given time, getting their governance right should leave them better positioned when circumstances change.

This inquiry will focus on the impact of governance on innovation, not the full range of factors that influence companies' decisions and behaviour. The purpose is to explore the extent to which companies' governance arrangements and the governance framework within which they operate encourage or deter innovation, and to identify good practices that – if more widely adopted – can help good governance to become an active driver of sustainable value creation.

The Centre will publish a report on its findings later this year which will include recommendations for action addressed to companies, investors and policymakers.

In addition to the research that we are undertaking, we want to hear as wide a range of views as possible before forming any conclusions. That is the reason for this call for evidence.

The call for evidence briefly outlines some of the issues that will be considered by the inquiry and contains questions on which we would welcome views. Please do not feel obliged to respond to all the questions, and if there are issues that you consider should be addressed by the inquiry that are not covered in this paper please feel free to highlight them and explain why you feel they are important.

While we are particularly keen to hear from company directors and executives about their experience, the views and perspectives of investors, policymakers, academics and others with an interest in encouraging business innovation would also be very welcome.

## How to respond

**The deadline for responding to the call for evidence is 12 August 2022.**

**Please send your comments by email (using the title 'Innovation Inquiry') to Georgia Holden, Coordinator for the IoD Centre for Corporate Governance: georgia.holden@iod.com**

Everyone who responds to the call for evidence will be invited to participate in online round table meetings at which the Centre will share our emerging findings and invite views on possible recommendations. These meetings are provisionally scheduled to take place in September 2022.

# Context for the inquiry

### The definition of business innovation

The OECD defines business innovation as "a new or improved product or business process (or combination thereof) that differs significantly from the firm's previous products or business processes and that has been introduced on the market or brought into use by the firm"[1]. This definition recognises that business innovation activities do not just encompass products, services and processes that are new to the market but also those that are new to each individual company.

This is an important clarification. Innovation can include finding new applications for current services and products, changing existing business processes, developing new products and services, using or creating new technologies, and changing management techniques. While only a relatively small number of companies will be innovation leaders, all companies can and should aim to be innovative in their own terms.

Meeting the economic and sustainability challenges that face the UK such as the transition to Net Zero will require both step-change and incremental innovation, and we will be addressing both in this inquiry. Having said that, highly innovative companies have a particularly important role to play, and one of the objectives of the inquiry is therefore to identify how governance can support rather than constrain innovation in these companies.

## Characteristics of highly innovative businesses

**Research[2] suggests that some of the common characteristics of highly innovative businesses are:**

1. They invest in activities with highly uncertain outcomes for which the likely commercial return is difficult to quantify and the risk of failure is significant;
2. They tend to require a longer-term time investment horizon than many other kinds of business activity;
3. They benefit from the availability of company specific skills, which may be highly specialised;
4. They have an internal culture which encourages flexibility, experimentation and a high level of individual initiative; but
5. There is a high level of information and expertise asymmetry between those directly involved in innovation and those that are not such as outside directors or external investors, making it difficult for the latter to assess the innovation properly.

1 'Oslo Manual: Guidelines for Collecting, Reporting and Using Data on Innovation'; OECD; 2018
2 'From Value Protection to Value Creation: Rethinking Corporate Governance Standards for Firm Innovation'; Roger Barker and Iris Chiu; Fordham Journal of Corporate and Financial Law; 2018

## Innovation in the UK

In many respects the UK has a good story to tell on innovation. In 2021 it was ranked as the fourth most innovative economy in the world[3]. However if you look below the headline it becomes apparent that our performance is mixed.

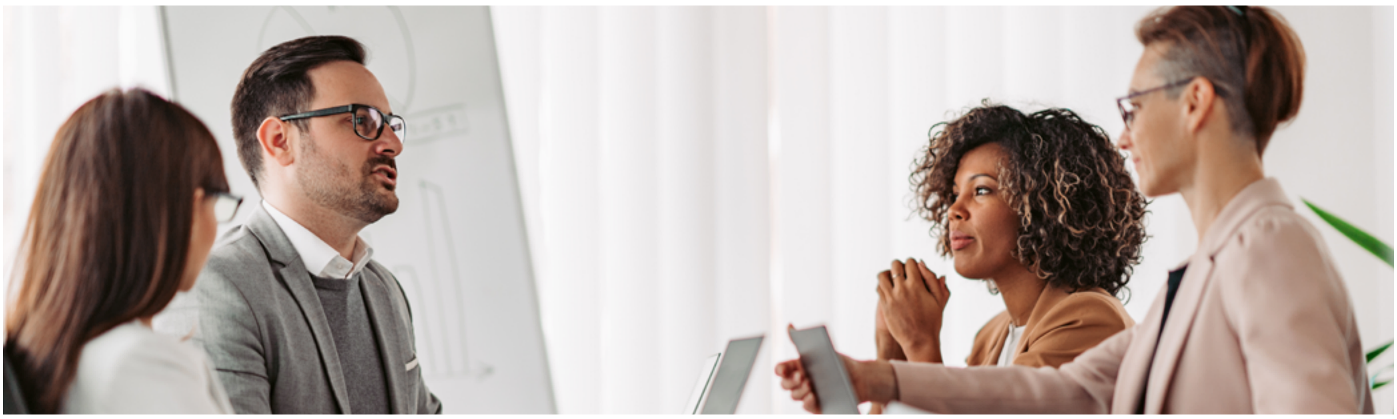
According to the most recent European Innovation Scorecard[4], which compares innovation performance across a range of indicators, while total business expenditure on R&D as a percentage of GDP is above the European average, expenditure on non-R&D innovation as a percentage of turnover and total innovation expenditure per employee are both below average.

Sales of new-to-market and new-to-enterprise innovations as a percentage of turnover by UK companies are also above the European average, as are exports of medium- and high technology products and knowledge-intensive services as a percentage of our total exports. On the other hand, the percentage of UK SMEs introducing product innovations (25%) was below the European average, while only 20% of them had introduced new or improved business processes compared to the European average of 40% of SMEs.

Other data sources show that, while the UK has attracted some of the highest levels of investment globally in innovation-led sectors such as FinTech and biotechnology, across the economy as a whole the level of business investment is lower than historic domestic levels and is lower in the UK than in other regions[5].

Taken together, this data would appear to suggest that while some UK companies and sectors are highly innovative many are not, and that this is not a problem that is confined just to large or listed companies. As noted, in order to generate sustainable value creation across the economy as a whole we need not only to nurture highly innovative companies but to tackle the long tail of non-innovative companies of all sizes.

One of the objectives of this inquiry is to identify whether there are common characteristics in the way that successful and highly innovative companies are governed and, if so, to consider whether there would be potential benefits in trying to replicate them in other companies. The Centre is undertaking research into this issue, the findings of which will be shared in the final report.



3 ‘2021 Global Innovation Index’; World Intellectual Property Organization; 2021
4 ‘European Innovation Scoreboard 2021: Annex B – Performance per indicator’; European Union; 2021
5 ‘A Question of Investment’; Tomorrow’s Company; 2018

# Issues for consideration

## In broad terms there are four main drivers that influence the governance of companies:

1. The board, which sets the company's strategy, culture and risk appetite and oversees the performance of management;
2. The company's internal processes and structures which embed the values, define responsibilities and the chain of accountability and establish the control systems;
3. The ownership structure, which can influence a company's time horizons and capital allocation decisions; and
4. The regulatory framework within which the company operates, including the legal duties of directors and the corporate governance standards set out in laws and codes.

In this inquiry the Centre will be assessing the impact of each of these factors on how companies approach and manage innovation, and would welcome views both on the specific questions listed below and on any other aspects of governance that you consider to be relevant.

### The role and composition of the board

The UK Corporate Governance Code describes the role of an "effective and entrepreneurial board" as being to "promote the long-term sustainable success of the company… establish the company's purpose, values and strategy… ensure that the necessary resources are in place… [and] establish a framework of prudent and effective controls, which enable risk to be assessed and managed"[6].

All of these aspects of the board's role are relevant to innovation. If the board lacks a clear long-term strategy, or has one that is more focused on survival than growth, it may be less likely to allocate sufficient resource to activities that might lead to innovative new products and processes. It needs to establish a culture that encourages and supports new ideas and accepts that some of them will not bear fruit, while at the same time ensuring there is appropriate oversight and control.

This is not an easy task. It is one thing to write policies and values, it is another thing entirely to embed an innovative culture. Management and the workforce will judge the board's commitment to innovation on the individual decisions that the board takes. Boards therefore need to consider at what point in the decision-making process to become involved and how to strike the right balance between supporting and scrutinising proposals from management.

Boards also need to have visibility of what innovative activity is going on within the company in order to assess whether the strategy and values are having the desired impact and exercise the necessary oversight. This should include engaging with management and receiving regular information including key performance indicators.

Getting the composition of the board right is crucial. The board needs to have relevant skills and experience to enable it to contribute to the development of a long-term sustainable strategy, constructively challenge proposals from management and inform individual innovation-related investment decisions. There is a view in some quarters that – at least in listed companies – the virtual absence of executive directors makes it harder to do so effectively. There is also a view that many non-executive directors are more risk averse than entrepreneurial in their mindset.

- **How can the board create a culture that encourages innovation? What information and indicators should the board use to assess whether they are succeeding in doing so?**
- **How does the board strike the right balance between its value creation and oversight roles and between supporting and scrutinising management?**
- **What features does the board need to have if it is to promote an innovative culture effectively, for example in terms of the balance of executive and non-executive directors and its collective skills and perspectives? What are the typical gaps and how can they best be filled?**

6 'UK Corporate Governance Code'; Financial Reporting Council; 2018

## The company's internal structures and processes

There are a number of common difficulties faced by boards which might impede their ability to address innovation effectively. These include crowded agendas, resulting in a lack of time to discuss issues in any depth, and the need for a greater range of skills and experiences than there is room for around the board table. Some companies aim to alleviate these difficulties by setting up some form of committee, whether that be a sub-committee of the board, a hybrid committee bringing together a mix of board members and managers, or an advisory committee that brings external expertise into the company.

Careful thought also needs to be given to the organisational structure and reporting lines at and below senior management level. One model is to 'ring fence' innovative activities within the company in some way, for example in order to protect their budgets or allow them greater licence to take risks, although there may be a danger that this approach makes it more difficult to embed an innovative culture across the organisation as a whole. Whatever model is chosen, it is important to ensure there are clear lines of accountability.

In addition to having a clear purpose and values, one of the main drivers of an organisation's culture is its approach to rewards and incentives – promotion, remuneration and so on. Companies can use their reward systems to incentivise innovation, although if doing so this needs to be carefully calibrated and monitored. There are no shortage of examples of companies inadvertently incentivising the wrong sort of behaviour.

- **Would the presence of either a board, hybrid or advisory committee reporting to the board improve the board's understanding and oversight of innovation?**
- **What is the best organisational structure for ensuring that innovation is sufficiently resourced and prioritised?**
- **Can the company's reward systems be used to incentivise innovative behaviour? If so how, and how can the danger of incentivising the wrong behaviour be avoided?**

### The ownership structure

The availability of risk capital is crucial to finance companies with a high growth and innovative potential, and the source of that capital can potentially have a significant impact on a company's ability to innovate.

The impact of ownership on longer-term investment and innovation is a topic that has been much discussed in relation to public listed companies. There is a view that some shareholders prioritise their own short-term interests to the detriment of the long-term health of investee companies, favouring dividends over reinvestment of profits. Investors dispute this perception, and many point out that they are increasingly incorporating long-term and ESG factors into their own investment decision-making and assessing investee companies' capital allocation policy as  part of their stewardship activities[7].

As with other aspects of governance, ownership is not a factor only for listed companies. Although research suggests that privately owned companies tend to invest a much greater proportion of their profits back into their business over time[8], private equity is not immune from the charge that it sometimes favours value extraction over value creation. While the interests of the company and owners will be closely aligned in founder and family owned companies, some of them may face other challenges such as difficulties in growing organically or a resistance to change.

- **Are certain ownership structures or types of owners more 'innovation friendly' than others? If so, why?**
- **Do external investors typically encourage their investee companies to be more innovative? How could they do so most effectively?**

7 'UK Corporate Governance Code'; Financial Reporting Council; 2018
8 'Measuring the Costs of Short-Termism'; Richard Davies, Andrew Haldane, Mette Neilsen and Silvia Pezzini; Journal of Financial Stability; 2014

### The regulatory framework

One of the reasons for the concern about the perceived undue influence of shareholders is the fact that the Companies Act 2006 has been widely interpreted as placing a duty on directors to prioritise the interests of shareholders over other considerations. The IoD is a supporter of the Better Business Act campaign[9] which is calling for a change to the law which would instead require directors to act in a manner most likely to advance the purpose of the company.

Regulators are also reinforcing the message about sustainable value creation. For example, in the most recent versions of the UK Corporate Governance Code and UK Stewardship Code the Financial Reporting Council encourages boards and investors respectively to take greater account of longer-term considerations in their decision-making.

However, there is a view that some of the standards set out in governance codes and rules may have had the unintended effect of creating boards whose mindset is overly risk averse and whose skillset leaves them ill-equipped to cultivate an innovative culture. More widely, other regulations affecting companies may have inadvertently put barriers in the way of innovation, for example by reducing flexibility.

That said, regulators can potentially also play an active role in encouraging innovation. One of the factors credited for the successful growth in the UK FinTech sector is the support provided by the Financial Conduct Authority, for example through its Regulatory Sandbox which provides companies with the opportunity to test innovative new products and services in a controlled environment. This is perhaps a good example of what is sometimes called 'agile regulation'.

- **Would a change to directors' duties as proposed by the Better Business Act campaign have any impact on directors' attitude to innovation?**
- **Is there anything in the existing governance rules and codes, or other regulation, that has the effect of inhibiting innovation?**
- **Apart from rules and codes, are there any actions regulators and policy makers could take to encourage innovation?**

9 https://betterbusinessact.org/

**About the IoD Centre for Corporate Governance**

The IoD Centre for Corporate Governance exists to explore current issues in corporate governance, company stewardship and ESG - for the benefit of the business community, IoD members and wider society. The Centre arises from the IoD's Royal Charter obligation to "promote the study, research and development of the law and practice of corporate governance". The Centre functions as an independent, not-for-profit centre of excellence under the umbrella of the IoD. Please note that views expressed in Centre publications do not necessarily reflect the position of the IoD or the Centre Advisory Board, and are solely the responsibility of the authors.

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