



# *How employee directors add value*

CORPORATE GOVERNANCE: CONNECT AND REFLECT



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## ***Connect and reflect***

Connect and Reflect is ICAEW's framework for a new era of corporate governance. We want to inspire companies to go beyond legal and regulatory requirements. If companies recognise the challenges they face and develop their own solutions, they will benefit. Although initiating a step change can seem like taking an unnecessary risk, in fact, in the modern environment, it is more dangerous to cling on to old stereotypes and outdated processes. Improving corporate governance is key to building trust in business, and ideas that may have seemed radical in the past are becoming mainstream.

## ***How employee directors add value***

Boards lie at the heart of everything that is right or wrong with companies. When a board works well, this is reflected in the company's success and reputation. The reverse is also true.

Boards need to keep what they do under review to ensure that they can meet new challenges and rising expectations. There can be no sacred cows when it comes to who sits on boards, how directors are chosen, the remit of individual directors or boards, or what boards do and do not need to know in order to make good decisions. To prepare for the future, companies should make an objective assessment of their boards with open minds that are not constrained by old ways of thinking.

In this paper we explain five ways in which employee directors can add value to boards, companies and employees. A full understanding of these advantages will prevent the idea of employee directors being prematurely dismissed as empty tokenism or political correctness. Companies will thrive when they see employees' views as central rather than peripheral. Making this leap will transform the appointment of employee directors from a daunting prospect into a logical step.

An understanding of the value that employee directors can bring forms the basis of a five-point Action Plan for boards. Once boards are persuaded that employee directors can be valuable assets, they will be receptive to our five steps to success.

# ***Five ways that employee directors add value***

## **1. MAKE HIERARCHIES WORK BETTER**

'Speaking truth to power' is a phrase which is used by those who are voiceless because they are at the bottom of dysfunctional hierarchies. The lesson is salutary; those in power may never know the truth unless somebody is courageous enough to speak up. Companies should be keen to do all they can to avoid this failure of governance.

In fact, the demarcation between who possesses the truth and who holds the power has blurred in many companies. The dynamic between boards and employees is not necessarily one of information asymmetry or knowledge imbalance. Management may not have more or better information than employees, and vice versa. Each group has its own information and perspective, and both will perform better if this information is shared.

### **MILITARY LEADERSHIP**

The success of military leaders depends upon loyalty and a willingness to close ranks when faced by an enemy. The military has a rigid hierarchy where leaders are vastly outnumbered by their subordinates. The functionality of relationships could be tested in combat, and this is one of the reasons why subordinates are often encouraged to voice their opinions which are respected even if they are not followed. This supports leaders' authority to make difficult decisions rather than undermining them.

Hierarchy is only important at turning points in the employment relationship. Some examples are when companies make decisions on recruitment, pay, disciplinary action, promotions and dismissals, and when employees make decisions like bringing a grievance or deciding whether to resign. Provided working relationships are generally healthy, at all other times, operational performance usually trumps hierarchy. People working on the ground tend to be more interested in getting the job done rather than who does what.

Boards should not underestimate employees' understanding of business opportunities and threats. Employees are a rich source of ideas and practical knowledge about the best way to reach the board's goals. Currently employees may not know the risks and opportunities being considered by the board, even though they could have constructive insights and important warnings. Employees have a valuable perspective on processes and products that are going well, problems on the horizon, and ideas for improvement. However, without employee directors to act as conduits, these insights and perspectives will not necessarily reach the board. Similarly, employee directors have a key role to play in helping employees understand the challenges and pressures of running a company which is sustainable in the long term.

Some start-up companies with young workforces are rejecting traditional management hierarchies and experimenting with flat structures. This may be because of a growing acceptance that no single group or individual can ever have all the answers. Employee directors are a way for companies to accommodate this trend within existing governance structures.

## 2. SUPPORT LONG-TERM THINKING

### FAN FOR LIFE

For many, supporting a particular sports team or club is a lifetime commitment which outlives almost any other aspect of their life. The pervasion of families and communities is unique and so tribal in nature that geographic and social mobility are almost irrelevant. Companies which can harness similar passion and commitment will reap significant rewards. The lesson is, people want to belong and they want to work together, including weathering failures and celebrating success.

Employees may have longer experiences of working for the company or in the sector than board members. The appointment of employee directors demonstrates that companies value the commitment of their employees. This may inspire other employees to take the initiative and deliver a range of projects which do not require board or management input.

Social media has empowered employees. In this environment, employees can be their company's strongest advocates or harshest critics, and what they say may be believed to a greater extent than what the CEO or any other official spokesperson has to say.

It is usually unrealistic to attempt to stop or slow employees' communications. However, a decision to recognise the importance of employees' perspective at board level may persuade some disenchanted employees to moderate their views. It will also boost the morale of other employees. For example, existing employees may stay with the company for longer than they intended, or talented candidates may be attracted to join the company if they see the potential to be appointed as an employee director as part of their ideal career path.

As employee directors are closer to employees and public opinion they can be powerful internal and external influencers. They could act as the board's internal spokesperson, eg, talk about their career with new recruits. They may also be prepared to make media appearances at times of crisis or change.

## 3. HELP WIDER STAKEHOLDER ENGAGEMENT

Employee directors prompt better employee engagement. Lessons learned from this process of improvement will develop companies' knowledge of what different stakeholder groups need or expect, which communication tools work best, the resources required and how to resolve any conflicts which may arise.

Advances in technology allow companies to communicate easily and at important moments in stakeholder relationships, ie, shortly after a customer has received a company's service or product. The imagination which companies have applied to customer engagement should be applied to employees, and in due course, to other stakeholder groups.

### DAVID v GOLIATH

This bible story warns those in power that they are always vulnerable if they take their position for granted. The story continues to inspire headlines in the run-up to sporting competitions because it perfectly describes an inclination to support the underdog. The moral is a simple one: respect everyone or risk disaster.

## 4. IMPROVE BOARD BEHAVIOUR

The introduction of employee directors should be a catalyst for boards to self-assess what they do, how and why. Employees are used to their performance being scrutinised by line managers. They may expect their fellow directors' performance to be assessed to the same degree. Other outcomes may be better board packs (clearer or shorter documentation), and better intra-board communications if existing directors take the opportunity to be brave and pose questions they have always wanted to ask.

### BOARDROOMS AND COURTROOMS

Life-changing decisions are the daily business of courtrooms and the advocates and judiciary which populate them. Lay participants experience a range of emotions, often nerves or fear, or sometimes anger or resentment. The atmosphere is highly-charged, but the environment functions through the use of norms and etiquette designed to provide comfort and structure. The advocates and judges who operate in this environment must present arguments they disagree with, and make difficult decisions they may feel uncomfortable with. They balance these pressures with maintaining cordial relationships with their fellow professionals who may oppose them one day and work alongside them the next.

## 5. ENHANCE BOARD CREDIBILITY

Positive employee relations are a prerequisite for a company's survival as well as for growth. Building a company where people want to work supports creating products that customers want to buy and delivering services customers want to use. Appointing employee directors, agreeing to be an employee director or voting for them, are all demonstrations of active involvement. Employees will have more confidence in the strategic decisions taken by boards if a peer has contributed to the process.

### GLASSDOOR

Glassdoor is a website that posts reviews of employers written by current and previous employees. Insiders' perspectives can be read by anybody who is considering working for, buying from or investing in the company. The site includes scores on a range of factors, such as whether the company would be recommended as a good workplace to a friend, and an approval rating for the CEO. There is also information on salary and benefits, and interview tips from candidates who have been through the recruitment process.

There are more commonalities than differences between employees and existing directors. There is also high interdependence. Both groups are financially invested in the company and reliant upon its success. Directors listening to board discussions may ponder whether the information they are receiving from executive directors is full and frank. Some may long for direct insights from the coalface on specific issues.

Companies have a broad mix of knowledge and experience available to them. Although employees usually only have one employer at a time, most employees with advanced careers will have gained experience with one or more previous employers. Some employees may sit on the boards of other organisations, eg, as a trustee of a charity or as a school governor. Others may speak international languages or have knowledge of overseas markets. For companies to Connect and Reflect with their employees, they must provide a framework which maximises all contributions, and employee directors are key.

# Action plan for boards

The strength of the arguments in favour of employee directors explains why they thrive in some countries. The reason why they barely exist in other countries may be because of perceived practical and diverse challenges associated, eg, including employees in one-tier boards, commercial confidentiality, the impact on other board members and the chair, concern about an inability to take tough employment decisions, and, finally, how to select a single or limited number of employee directors from a diverse, multisite or multinational workforce. Taking a business-like approach and following the five-point Action Plan set out in the remainder of this paper will help ensure that excuses are separated from legitimate challenges, and that solutions are found.

## 1. GET BUY-IN

Boards need to take the initial decision to appoint employee directors. This includes deciding if one employee director is sufficient, or if two or more employee directors are needed in order to achieve optimum board composition. Boards (in consultation with the company secretary) may decide that, for ease of administration, employee directors' terms and tenures should coincide with those of other directors.

Employees should provide input on how all of the other practicalities should operate. We suggest that this consultation process commences simply by talking, starting with reiterating what may seem obvious, which is that the company wants its employees to feel excited about their contribution and employees want to work for a company which respects their opinions. There needs to be an acknowledgement that getting to this ideal situation requires effort and a willingness to take risks by both sides.

### LOCAL AUTHORITIES

In some circumstances, the electorate are asked to vote on their preferred governance model for their local authority, ie, whether there should be a Mayor, or a Leader supported by a Cabinet Executive. This choice reflects the interdependence of local authorities and communities. Councillors are elected by local communities, and they make critical budget decisions which affect services that communities rely upon.

Practical and legal questions will arise. It may be possible for the company to anticipate some of these questions in advance, and to prepare a range of possible answers; but boards should not reach any conclusions until their consultation with employees has closed. Companies may choose to engage external facilitators and specialists to manage the consultation process, but it would set the right tone if the CEO or other board directors felt able to communicate directly with employees.

The objective should be to reach consensus on the key issues and processes. Consensus is not the same as unanimity. There will always be cynics and contrarians, and listening to their objections will help to strengthen the positive arguments. Those conducting the consultation should not presume that all board directors will be hesitant or all employees will be enthusiastic. Views may be less predictable or polarised, and viewpoints may change if persuasive arguments are made and practical questions are answered convincingly.

It may be helpful to consult major shareholders who may like the idea of employee directors, especially if their understanding of ROI has already gone beyond 'Return on Investment' to also include 'Return on Inclusion'.

## 2. FIND THE RIGHT PEOPLE

There are no prohibitions or prescribed rules for how to identify employee directors, but, to be credible, the process must be transparent and democratic. It is important to bear in mind that the process will be funded by companies and that it will be repeated on a regular basis. Companies may wish to steer the debate by outlining alternative processes for employees to choose from. However, companies should remain open to persuasive arguments about the possible advantages of combining these options and to other suggestions.

It may be helpful to break the process down into stages. Criteria for candidates should be one of the first things decided, and it may be one of the more controversial areas. The geographic location and seniority of candidates could be valid criteria. Boards may also want to take the opportunity to fill any gap in their knowledge or skills, eg, social media. Respecting the confidentiality of some board information is critical, and therefore this issue should be emphasised on a regular basis.

Most companies will need a process for creating an initial pool of candidates. Companies and employees need to decide how eligible candidates will join this pool, ie, self-selection, nomination by a limited number of employees, or localised or company-wide elections.

The process for the final selection of employee directors may have echoes in the nomination process, or it may be completely different. If elections are used at any stage, then the question of who is eligible to vote is likely to arise, especially in multinational companies and in companies where not all workers are employees. It may be possible to keep voting rights simple by allowing each employee one vote; or, it may be fairer for votes to be weighted, eg, with reference to the number of hours worked.

Companies should consider whether they should be able to veto candidates in extreme circumstances, eg, if a candidate is subject to disciplinary action by the company or under investigation by a government agency or regulator. The issue of what will happen if an employee director resigns from the board or leaves the company altogether also needs to be covered.

A trial period could have value. Companies and employees may agree to reassess the mutual value of employee directors when the first employee director or directors reach the end of their first term. Employee directors, other directors, chairs and employees should be given an opportunity to share their opinions about how things have worked in practice and present their ideas for improvement.

### HEADS UP

Other organisations have identified their critical stakeholder groups and found ways to appoint representatives to their boards. Housing associations form tenants' associations, universities have student directors and pension schemes have member-nominated trustees or directors.

The coffee company Café Direct has an ethos that led them to appoint a consumer representative, two non-executive directors who represent producer organisations in the developing world and two shareholder directors.

## 3. EXPLAIN RESPONSIBILITIES

It must be made clear from the outset that employee directors have the same rights, responsibilities and duties as all other directors. This has the great advantage of simplicity and it avoids getting swamped by technicalities. The approach may encourage enthusiasm in some potential candidates, and discourage others from putting themselves forward.

## MUSICAL CHAIRS

President Johnson's attempts at peace talks were frustrated by furniture. The US proposed two long tables facing each other. North Vietnam objected on the basis that they did not recognise the South Vietnamese government because their election had been delayed. They also wanted the National Liberation Front and North Vietnamese Army to be represented. North Vietnam suggested a four-sided table, but South Vietnam objected because they did not agree that all four parties should have equal status in the negotiations. For several weeks important diplomatic work was replaced by sketching table designs. Broken parallelograms, four arcs of a circle, a flattened eclipse and two semi-circles that touched but did not form a circle were all considered. Eventually the Soviet Union's suggestion was accepted: two roundtables for the two Vietnamese governments and two nearby square tables for the National Liberation Front and North Vietnamese Army. Ultimately these peace talks failed. The war continued for several more years with thousands of lives lost.

Employee directors are expected to offer advice and opinions based on their own knowledge and experience, in common with all other directors. Employee directors will draw on their direct experience as an employee, as well as the experiences and views that they have picked up from other employees. The role of employee directors is to close the gap between the boardroom and the coalface. They are a conduit for upwards and downwards communications. To succeed, employee directors must not fall into the trap of being apologists for board decisions, and they must be trusted to an extent that when they say there is no news this is believed.

Employees' perspective is just one of a host of issues that employee directors need to take into consideration when considering board issues. The inclusion of employee directors on a board does not mean that employees' opinions will always override other considerations, but it does mean that their opinions cannot be ignored or overlooked. Employee grievances should continue to be dealt with by Human Resources and not at board level.

Offering additional remuneration to employee directors would be inconsistent with the objectives of the role, but there should be an allowance for the time commitment involved in being a company director with special responsibility for employees.

## 4. SET UP CHANNELS OF ENGAGEMENT

Employees who are considering standing as employee directors may wonder how they will collate employees' views. They may question how they will communicate non-confidential and relevant board information to employees, and whether they are allowed to answer all their colleagues' questions.

## EMPLOYEE ENGAGEMENT 'DOES IT' FOR B&Q

B&Q, the home improvement company, won the Gallup Great Workplace award. The company holds regular 'grass roots' meetings. Employee communication forums are staged in all stores and then regionally, divisionally and nationally. Each manager has an employee-engagement action plan, which is built using input from their team, and effective engagement is a key measure of success for all B&Q managers.

Choice of engagement channels should be based on ease of participation so that employees who do not feel confident about public speaking are not left out. It may be possible to repurpose current engagement mechanisms if employees agree that they are effective. Employee directors and their line managers need to consider how they will deal with requests by individual or groups of employees to meet with an employee director.

Employee surveys are a popular engagement mechanism. When surveys are conducted electronically they have the added advantage of anonymity which can encourage nervous employees to be candid. The increase or decrease in survey responses year-on-year can be more important than the feedback received. Although employees do not receive a personalised response to the points they make when they respond to a survey, most companies follow-up on areas of concern in an effort to improve the following year's results and increase the response rate. It may be possible to integrate employee directors into surveys. For example, elections could be added to surveys, or employee directors might want to pose some specific questions, perhaps on the basis that only they are allowed to read the responses to the questions they asked.

Another example of an existing employee engagement mechanism is town hall events. These face-to-face internal communications allow direct communication between senior managers and large audiences of their employees. Town halls may be held at times of crisis, or on a regular basis, or both. Employees are given an opportunity to ask questions and receive on-the-record responses. Town halls could be adapted in order to provide a platform for employee directors to communicate with employees.

Employee panels raise similar questions to those which arise in relation to the identification of employee directors. For instance, who decides who sits on the panel and how, the tenure and role of panel members, and how all employees' views are reflected in panel discussions. The relationship between employee directors and panels needs to be debated and then made clear; in other words, whether only panel members are eligible to be an employee director or to select employee directors.

## 5. PROVIDE PERSONAL SUPPORT

Existing directors may be concerned about the impact of employee directors. They may have concerns about potential breaches of confidentiality, delays in decision-making and hampering of restructures if they include redundancies. Chairs may share these concerns, and they may seek assurances that boardroom norms will continue to be observed, such as time keeping and respecting the views of others. These practical concerns must be addressed in employee directors' inductions and in communications to other board members.

Employee directors' line managers must not be forgotten. They will need guidance about how their subordinate's additional role does not diminish expectations of their primary role, or diminish the line manager's position, and whether any changes are needed to employee directors' appraisals or objectives.

### WHAT MAKES A GOOD LEADER

In Japanese companies, promotion to management status is not based on assertiveness or quick decision-making, but on the ability to create consensus, taking into account the needs of subordinates. This is based on the Japanese management technique of 'ringiseido', which is the opportunity for equal ranking of managers and employees in order to exchange ideas.

Support may have to extend beyond the practical to cover the personal and pastoral. In the early days, teething problems may test resolve. Provided the company provides this support and concerns are taken seriously, it is not unreasonable to expect employee directors, their line managers and existing directors to be flexible and adapt. An initial agreed understanding of the benefits of employee directors will provide a solid foundation for not blowing issues out of proportion and not giving up too easily.

## Conclusion

The current perception of governance is that it is based on processes which only specialists can understand, structures which serve an elite group and rigid rules which discourage change.

A decision to appoint one or more employee directors will breathe new life into governance by making it accessible and relevant. Companies exploring the possibility of one or more employee directors will show that they are not complacent about the status quo or reticent about making real change. They will demonstrate their determination to improve diversity, and illustrate their optimism for the future by preparing for it.

Although employee directors may seem a significant shift, they do not require any significant change to existing board structures. Modernisation is far more challenging for some other institutions.

### REFORMING THE HOUSE OF LORDS

The UK's legislature has a Lower and Upper House. However, these labels are misleading as responsibility and accountability resides in the Lower House, the House of Commons.

The grant of new hereditary peerages has dwindled, but the arguments centring on the necessity and role of the Upper House continue to be conflated with broader concerns about meritocracy versus nepotism and privilege.

The latest suggestions for reform of the House of Lords centre on reducing the size of the membership, with all or the majority of peers being elected. More controversial suggestions are a system of allotment (random selection of peers from the whole or part of the electorate) or abolition.

The failure of recent reform initiatives reflects the complexity of the composition considerations: ensuring the right skills and experience; balancing continuity with fresh blood; and preventing a constitutional clash between appointed and elected members.

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