Guidance for Boards

# CHALLENGES FACING PUBLIC SECTOR BOARDS

Public sector boards face a set of unique challenges. The first step to overcoming them is know what they are.

1 CPD hour

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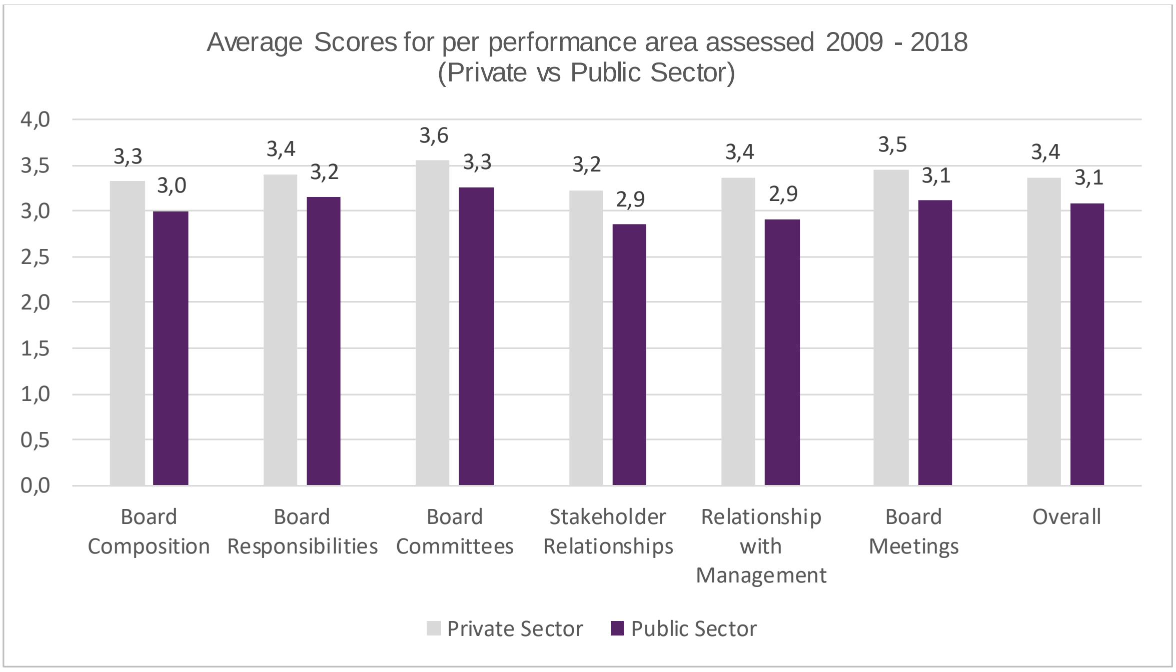
# Challenges facing Public Sector Boards

## INTRODUCTION

The boards[1] of public sector entities often receive bad press. The trouble that many public sector entities find themselves in can often be traced to poor governance practices, and thus reflects badly on their boards.

One point that needs to be made, based on quantitative data from the many board evaluations conducted by the Institute of Directors in South Africa (IoDSA) over the past 11 years (2009 to 2018), is that public sector boards generally underperform relative to those in the private sector, but the quantitative disparity is not as great as one might expect. As can be seen from the figure below, the gap in self-assessment scoring is not too glaring in most instances.




However, qualitative findings from interviews with directors in the public sector paint a clearer picture of the challenges facing public sector governance. It is therefore very important to interrogate the reasons for this underperformance, in order to provide boards with insight into the areas on which they should focus. Given the important role that public sector entities play in the economy and national life generally, every effort should be made to improve governance and to support improved board performance.

At the outset, it is worth noting that there are specific challenges faced by the boards of public entities. The main one is that there are no clear lines of accountability amongst the various levels of governance role players. This is because the government, as sole or chief shareholder, holds overwhelming power and influence, which sometimes leads to interference.

[1] For the sake of clarity and simplicity, the term "board" is used in this paper rather than the more inclusive "governing body" used in King IV.

As a result, public entities are often required to be financially viable, while also implementing government policies. These two goals are frequently incompatible. In other cases, appointments to the management team or board can often be made by the shareholder without due consideration for their skills, experience or independence.

Because governance is not its primary responsibility, and because it is the sole or majority shareholder, government is essentially able to influence boards in a way that private sector shareholders are not. Unfortunately, this power is not always wielded responsibly or even with a stable strategic goal in mind. This poses challenges to the board members on these entities—especially with regards to their fiduciary duty, which is owed to the entity rather than the shareholder.

However, the publication of King IV, with its supplement for public entities, goes a long way towards providing guidance about how to apply these corporate governance principles within the public sector.

Before addressing the various common governance challenges in detail, it is worth reminding ourselves just how important the governance of public sector entities really is. To quote from King IV's Supplement for State Owned Entities:

> “*As the Presidential Review Committee on State-owned Enterprises makes clear, state-owned enterprises (which include state-owned entities (SOEs)), create the foundation that underpins economic growth and transformation, and thus have an important part in addressing the economic and social challenges facing the country…. Good corporate governance is paramount to the success of the SOE itself, and to protect and advance the interests of the country and its citizenry. Governance helps enhance the functioning of leadership structures of an SOE, and provides the arrangements by which the SOE should be governed so that it is able to meet its strategic objectives.”*

## BOARD COMPOSITION

Board members with the right experience and skills are a substantial contributor to good board performance. The nominations process is thus a critical one, as is proper succession planning. However, even if a nominations process exists, in practice public sector boards frequently find that board and executive appointments are made directly by an individual, the Minister, as representative of the powerful single shareholder.

Ideally, before board members are appointed they should be subject to proper due diligence that includes an assessment of whether they possess competencies deemed to be critical by the organisation. Such an assessment should be conducted by a professional body accredited to provide competency assessments. At present, this is not a requirement when it comes to appointing members of public sector boards. As a result, the rationale for a large number of appointments in the public sector is not transparent, thus eroding public trust and confidence in both the board and the organisation itself.

Ministers sometimes appoint appropriate people to these positions but sometimes they do not, being swayed by considerations unrelated to director competencies and the needs of the board and the organisation as a whole. It is of the utmost importance that this important process is not left at the mercy of political and policy vagaries. Even though the final decision on appointments will probably never be ceded by government, boards should find ways of ensuring that they have input into the overall skills and experience of the board as a collective.

King IV offers some general guidance. In respect of the appointment of board members, it states: “Even when accounting authorities [i.e. boards] do not have the power to nominate or elect members, they should actively seek to collaborate with the shareholder on this critical issue. The SOE and the executive authority should be transparent regarding the processes followed for the nomination, election and appointment of governing body members."[2]

The same approach is advocated when it comes to appointing the Chief Executive Officer (CEO). Even though the shareholder may have the legal right to appoint this individual, "the appointment of the CEO of an SOE should be a robust and transparent process that involves the accounting authority to the greatest extent possible, even if the shareholder has the right to make the final appointment."[3] King IV goes on to recommend explicitly that the shareholder and accounting authority should agree that the CEO reports to the board, and that this should be made clear in his or her letter of appointment. It should also be clarified in the Shareholder Compact (see section below).

As a matter of best practice, the CEO should only be appointed from a shortlist made up of candidates assessed and approved by the board or its nominations committee. All of these candidates should have been found to meet the required levels of competence required by the CEO position, and should enjoy the board's absolute confidence. Boards must therefore resist any pressure to shortlist a particular candidate unless he or she has demonstrable competence in the required skills.

In the event that the shareholder does not adopt such best practice, the board should engage robustly with it to make the case. Perhaps the strongest argument it can make is that appointees perceived to be political will not command the respect of stakeholders, and will thus find it hard to be effective. Because of the close link between board composition, board performance and the success of the organisation, it is worth emphasising that not only should appointees have the necessary skills and experience, they should also be ethical, courageous and independent-minded.

**Recommendations for public sector boards/ directors:**

- Perform a proper due diligence before accepting an appointment.
- Understand the skills matrix and skills gaps of the board.
- Engage with the Minister on the skills needs of the board.
- Engage with the Minister on the board's criteria relating to executives to be appointed.
- Hold the CEO and other executives accountable to the board despite them being appointed by the Minister.
- In cases where the shareholder insists on making the CEO or other executive appointments, the board should insist that the final choice should be drawn from a shortlist of appropriately evaluated candidates that it is confident meets the required standards of competence in terms of performance and conduct.
- Ensure the Shareholder Compact clearly covers these areas to provide the board with the necessary power and authority.
- Ensure individual director peer evaluations are conducted regularly and are taken into account when re-nominating or re-electing members. These evaluations should be used by the chair of the board, and even the shareholder, to identify and manage underperforming board members.

## ROLE CLARITY

Many of the challenges around public sector board performance can be traced to overreach by the shareholder. More generally, this overreach also contributes to a lack of role clarity when it comes to the relationship between the board, management and the shareholder.

One consequence can be that the board can fall into the trap of showing undue deference to an assertive shareholder, and fails to exercise its duties and oversight independently. Another is that the CEO thinks

[2] King IV, p 115.
[3] King IV, p 116.

he/ she is accountable directly to the Minister who appointed him or her, and not to the board. As noted above, the solution is for the board and shareholder to agree to make the CEO responsible to the board, and to note this in the letter of appointment.

The key to improving role clarity, especially given the special circumstances of the public sector, is to ensure regular communication between the board, management and the shareholder.

**Recommendations for public sector boards/ directors:**

- Understand the role of each layer of governance by using an independent service provider to provide training to increase knowledge, understanding and buy in from all levels.
- Push back on an overreaching shareholder if the board's rights or prerogatives are being infringed.
- Exercise independent oversight, regardless of how/ by whom you were appointed.
- Communicate regularly with shareholder and management.
- Ensure that the Shareholder Compact clearly defines the role, responsibilities and authority of the shareholder and board.

## BOARD ROTATION

Public sector boards would benefit from a more carefully thought-through system of board rotation that balances the need to access fresh thinking and new skills on the one hand, and the imperative for continuity and institutional knowledge on the other.

The public sector's common practice of "rotating" the whole (or a significant portion of the) board at the same time every few years, or for some other reason, is highly counterproductive, and robs the board and the organisation as a whole of institutional memory. By contrast, a well-constructed and staggered rotation programme would retain valuable skills and maintain continuity of knowledge and experience whilst introducing new ideas and expertise.

The question of board rotation dovetails into the equally important one of succession planning. Succession plans for key positions like the chair, the deputy chair/ lead independent director (as recommended by King IV) and the CEO should be in place to ensure the organisation is never left in a vacuum.

**Recommendations for public sector boards/ directors:**

- Engage with the Minister to encourage a staggered rotation plan for the board.
- Encourage the Minister to have succession pools for boards, and regularly update potential candidates with information on their performance in the various entities on which they might serve.
- Create formal succession plans for key positions (including emergency back-ups).
- Include policies, procedures or other appropriate charters relating to rotation in the process for selection.
- Ensure the Shareholder Compact covers staggered rotation of the board.

## BOARD COMMITTEES

Public sector boards need to be much more realistic about the number of board committees they create, how large each committee is, and who committee members are. Committee members must have specific knowledge, skills and experience in order to fulfil their functions effectively.

A sensitive issue that the board should confront squarely is that the way committee members are paid may influence the number of meetings. Because it is common in the public sector to pay members per meeting, there is a tendency for board committees to schedule far too many meetings. The same considerations might also explain why some board committees have too many members.

Another challenge is the sheer number of committees: some public sector boards have more committees than they have members. On the flipside, some boards are too small to make any committees viable. The latter might consider meeting more frequently, with different themes for each meeting.

On a more general note, it's important that board committees (as well as the board itself) maintain a strategic and oversight focus, rather than an operational one.

**Recommendations to public sector boards/ directors:**

- Reconsider how many board committees are necessary and what skills they need, based on relevant skills and experience.
- Hold committee members to account for the number of meetings that take place, and the quality of the output from those meetings.
- Reconsider changing director remuneration from a per-meeting fee to a per-annum one.

## BOARD ADMINISTRATION AND CHAIRING

It is hard to over emphasise the importance of board meetings—they are, after all, where the real discussions take place and the decisions are made. Great care needs to be taken to provide the right conditions to make these meetings constructive.

IoDSA data indicates an anomaly in this area. On the one hand, board meetings score higher than other performance areas while, on the other, interviews with public sector directors indicate that the reality is not nearly so satisfactory. Key issues are:

- **Poor administration:** It is felt that board packs are often delivered late so that directors have inadequate time to prepare for meetings, thus degrading the quality of both the discussion and the eventual decision.

  Another issue frequently highlighted is the inadequacy of the board packs themselves. All too often, they contain too much information. Boards need to guide management around the type and quantum of information that is useful, and management must apply its mind to identifying the most pertinent information. The tendency simply to dump as much information as possible on the board may indicate a lack of trust between the board and management.

  A final issue is the quality of the minutes. A transcription of the board meeting runs the risk of providing too much information. Proper minutes that summarise main discussion points, and that highlight decisions and action points, are more useful. By the same token, agendas are often too long, cutting down on the time for discussion available for individual items.

- **Poor quality of chairing:** Interviews with public sector directors reveal that too often board meetings get side-tracked into operational matters, and matters already decided in a board committee are reopened. Other problems include board resolutions not being implemented, or previous discussions rehashed, often with the result that previous board resolutions are overturned by new arguments as opposed to new or changed information.

**Recommendations to public sector boards/ directors:**

- Hold the company secretary accountable for the timing and quality of information (packs and minutes) provided to the board.
- Ensure proper and timeous planning of meeting dates so that the company secretary can plan an appropriate flow of information to boards and board committees.
- Management must be held to account for providing the necessary information in line with this plan.
- Hold management to account for the quality of information supplied to the board, and provide ongoing feedback in this regard.
- Perform regular evaluations of key role players like the chair, CEO and company secretary.

## MEASUREMENT AND IMPACT

Boards need to develop ways of understanding what impact they are having on the organisation, and what impact the organisation is having on the creation of value for stakeholders, wider economy and society. This is particularly important for public sector boards because their organisations are explicitly intended to contribute to the public good—profit is not their primary motive, and typically cannot be used as a proxy for success.

Boards should thus develop measures that allow directors to understand and track how value is created in the organisation, and the impact of their decisions on these key metrics. Outcomes-based performance measures are particularly important in the public sector because these entities typically exist within a complex legal framework.

As already noted, they are often subject to multiple laws, which may lead to a compliance-focused mindset. Such a mindset in turn can easily create an approach based on “What can we get away with?” rather than one focused on “How do we achieve the organisation’s strategic goals and create value within the applicable legal and governance framework?”

**Recommendations to public sector boards/ directors:**

- Spend time understanding the impact of the board on the entity, and the entity on society as a whole across all six capitals (as set out in the International Integrated Reporting Council’s (IIRC) Integrated Reporting Framework, which are financial, manufactured, human, intellectual, natural and social and relationship capital).
- Regularly assess whether the board is steering the entity to achieve what it was created to achieve.
- Follow an outcomes based approach rather than a compliance-based approach to governance.
- Commission broad impact assessments across all six capitals every three to five years to ensure that the entity is on track to deliver on its wider mandate.

## ASSURANCE

A related issue is the need for boards to ensure that assurance is undertaken to check whether the organisation as a whole, and its constituent parts, are functioning well. The board should interrogate who is providing that assurance, and call for outside expertise if necessary. In principle, boards should not view the calling request for more assurance as a sign of weakness, but rather one of strength. It is wisdom to know what one does not know, and who to call on to bridge the knowledge gap. The role and independence of assurance providers should also be understood and maintained.

It goes without saying that performance management and rewards of executives should be linked to strategic outcomes.

**Recommendations to public sector boards/ directors:**

- Commission and co-ordinate the efforts of the various assurance providers to assist the board in discharging its responsibilities.
- Implement a Combined Assurance model.

## COMPANY SECRETARY

Public sector boards should recognise that the company secretary is an important agent in enabling good corporate governance in the entity, and should fight hard to protect his/ her role and independence.

**Recommendations to public sector boards/ directors:**

- Ensure that the company secretary is appropriately skilled.
- Use the company secretary as governance gate keeper and advisor to the board.

## SHAREHOLDER COMPACT

Given the unique structural challenges relating to governance in the public sector, and the ever-present danger of the role of the board and shareholder becoming confused, board's will rely heavily on a written agreement with the shareholder (the Shareholder Compact) that spells out each party's roles and responsibilities. The Shareholder Compact should address the issues highlighted above and in King IV, and should include specific concerns relating to role clarity, responsibilities and other concerns. It should also be renewed and updated annually.

**Recommendations for public sector boards/ directors:**

- Spend time getting the Shareholder Compact right and keep it updated. This should include a deep understanding of what is required of the entity.
- Actively drive necessary changes to the Shareholder Compact. For example, ensure that the Shareholder Compact provides the board with the ability to nominate directors to the Minister for appointment and that appointment can only be from the list of directors nominated by the board. In addition, the selection criteria can also be included in the Shareholder Compact and/or specifically stated that these should be determined by the board in accordance with the board's composition and skills requirements.
- Push back on overreach of the shareholder based on a well-drafted Shareholder Compact.
- Never lose sight of the fact that board members must primarily serve the best interests of the entity. Board members must also have a keen understanding of the expectations, needs and interests of all key stakeholders, and work to balance these whilst gaining the trust and confidence of all stakeholders.

## CONCLUSION

Public entities have a critical role to play in rebuilding the economy and igniting inclusive growth. Their ability to fulfil this role is dependent on the effectiveness of their boards. Even though there are systemic challenges, as described above, it is possible to overcome them with the right knowledge, leadership and energy. King IV, as the pre-eminent guideline for effective corporate governance in South Africa should be used to help boards understand their obligations and how to fulfil them.

# Notes

## HOW CAN WE HELP YOU?

| Individual Services | Corporate Services | Thought Leadership |
|---|---|---|
| - IoDSA Membership<br>- NED Vacancies<br>- Director Certifications<br>- Individual Director Development Programmes | - Customised Board Development Programmes<br>- Board Performance Evaluations<br>- Governance Advisory Services | - King Reports and Practice Notes<br>- General Board Guidance<br>- Board Committee Guidance<br>- Research Projects |