Start-up Governance Navigator

By EY and IVCA in association with Pratithi Investments

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PROMOTING ALTERNATE CAPITAL ECOSYSTEM

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Foreword

EY

In today's age of innovation, Indian start-ups are leading the charge by revolutionizing various sectors, creating ground-breaking solutions powered by AI, robotics, and IoT, building a more automated, interconnected, and efficient future. With an unprecedented appetite for growth, the Indian start-up ecosystem has evolved at a breath-taking pace and continues to proliferate. Given the significant shift in India's entrepreneurial ambitions gaining global attention, it is crucial for these companies to sustain their remarkable growth momentum, even in the face of geopolitical risks and evolving market challenges.

As leaders in innovation, these new businesses have a crucial role in setting a positive example by making good governance a priority right from the start. Their advantage lies in the correlation between adhering to principles of good governance principles and ensuring a consistent path toward steady growth. This interdependency can be leveraged to create a strong ethical framework. Having such a framework is not just about meeting regulations; it also assists the start-up in putting in place methods that secure long-term success.

As start-ups navigate the complexities of an ever-evolving regulatory landscape, it is important for them to incorporate corporate governance to establish integrity within the company. New ventures stand to benefit from the learnings of their experienced contemporaries and can adopt practices to help them get the right start.

At EY, we are committed to helping companies on their journey to achieve optimum balance between sound governance and steady growth. We have put this report together with the intention of imparting our cumulative knowledge to help new entrepreneurs make informed governance decisions. We hope you leverage this guide as a blueprint while planning the course that your company will chart over the initial years.

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IVCA

The Indian start-up ecosystem, which has emerged as the third largest destination for private investment in terms of deals' value in the world today, was formalized by the government less than a decade ago in 2016. Rapid expansion is an exciting phase for any young company. Time and again, we have noticed that without a safety belt in the form of good governance practices, start-ups grapple to maintain internal controls and structures.

Very swift expansion may lead to lack of guidance on proper governance structures and internal controls. It is in response to this pressing need that the Indian Venture & Alternate Capital Association (IVCA), co-partnered with EY to present the "Start-up Governance Navigator" report.

This report—the result of extensive collaboration and insightful research—is designed to provide a comprehensive integrity framework from the ground up. The primary objective is to empower organizations to cultivate a strong ethical outlook and craft governance policies that align seamlessly with their vision. By doing so, this report aims to offer a proactive solution that not only reassures investors but also equips businesses to identify and address governance issues before they can escalate, thereby preventing fraud and malpractice.

We understand that one size does not fit all. The uniqueness of each organization and the specific challenges they face necessitate a tailored approach to integrity and compliance. Therefore, this report underscores the importance of management curating their integrity agenda to suit their circumstances. To further support the ecosystem, it presents a sample integrity agenda for fund managers and investors. Drawing from best practices observed while working closely with a vast array of start-ups and investors across the country, it serves as a valuable resource for managing portfolios and evaluating potential investments.

Additionally, the report advocates an integrated approach to due diligence and vigilance by various stakeholders, which can significantly reduce the incidence of poor governance.

As President of IVCA, I believe that the report, "Start-up Governance Navigator", is a step in the right direction. It is a commitment to a future where Indian start-ups excel in their respective fields while fostering cooperation and collective vigilance, to create an environment where ethical business practices become the norm rather than the exception.

Rajat Tandon, President

Indian Private Equity & Venture Capital Association (IVCA)

Pratithi Investments

We are going through a boom in Indian start-ups, as more Indian entrepreneurs step up to tackle large challenges in the country and globally. Domestic investors are also increasingly participating in this industry where there is great potential for value creation.

Start-ups operate in untested, novel markets where they are setting the rules. Most entrepreneurs are dealing with new challenges everyday, as they grow rapidly from a team of 3-4 to a large organization, handling hundreds of millions of dollars of funding and revenue. Softer issues like internal culture and processes need to be built out in the early stages, as they are difficult to correct later. A base of good governance can help companies and founders attract the right people to hire, work with larger customers on a basis of trust, and also pave the way for future funding. Key investors, such as significant angels and institutional investors, can help companies build this foundation through their experience of having seen this journey multiple times.

The Indian start-up ecosystem is still evolving. This is the right time for us to build a template for growing companies to refer to, so that they take all the right steps in their path to building sustainable organizations that can stand the test of time.

Kris Gopalakrishnan

Founder, Pratithi Investments

The power of starting right

The Indian start-up ecosystem continues to scale new heights, with disruptive models and technologies creating new markets and enabling further innovation. Many start-ups that emerged less than a decade ago have now become national players and are listed on the largest stock exchanges. Several others have attained unicorn status over the last decade. In such a fast-moving atmosphere, we need to be proactive to ensure promising start-ups and the founding teams behind them do not stumble due to inadequate internal controls and weak compliance practices. It is imperative to provide a strong foundation of ethics and compliance based on a scalable model that can grow as the company's operation progresses. A unidirectional approach to success by tracking merely the financial metrics is no longer enough; adopting good governance practices will help companies set themselves up for long-term success.

Building a robust integrity framework from the ground up will enable organizations to shape their ethical outlook and draft policies that are in accordance with their vision for governance.

This will not only reassure investors that they are invested in a company that values integrity and complies with the law but also help the company nip governance issues in the bud and prevent fraud.

In this report, we have sought to set out the actionable insights gathered from our study of several challenges that investors face while conducting their diligence of new investments and oversight over portfolio companies.

Laying down a foundation of ethics

Corporate governance is the system of rules, practices, and processes by which a company is directed and controlled such that it operates in a legally compliant, transparent, and ethical manner. Strong internal governance is not a cost center, but rather a long-term investment that pays dividends in the form of:

01 | Investor confidence:

Investors seek companies that maintain transparency, protect shareholders' rights, and allow active investor participation.

02 | Risk mitigation:

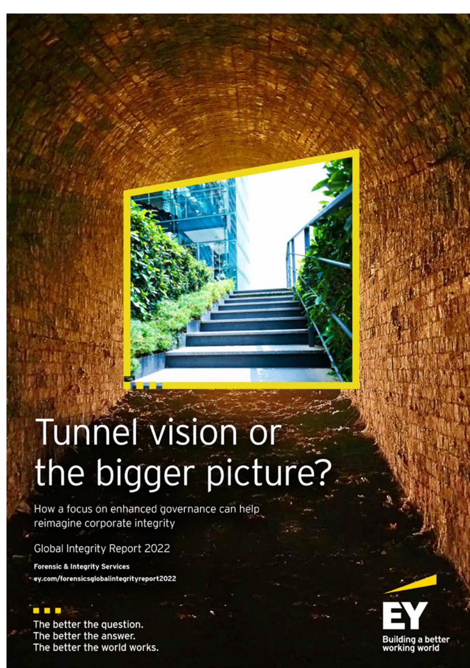
In the absence of strong governance structures, companies, shareholders can lose significant value due to the missteps of a few.

03 | Culture:

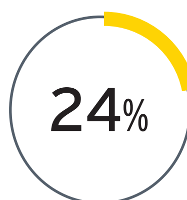
When the top management demonstrates their commitment to good governance, the company stands a better chance of building a strong foundation rooted in integrity and ethics with adequate oversight.

04 | Branding:

Customers, clients, and vendors want to work with organizations that are reputed to be well-governed and that protect the interests of all their stakeholders.



According to the EY Global Integrity Report 2022



of respondents felt the integrity of the management at the company was a more significant risk than cybersecurity risk while acquiring, partnering, or investing in other organizations. An effective governance mechanism can help identify early warning signs, preserve value and reputation, and enhance the visibility of KPIs.

Adapting to the ever-changing global market dynamics: assess your risk appetite

The past few years have seen the risk landscape undergo a sea change. The adoption of digitalization and automation across sectors has both enabled better monitoring as well as given rise to higher risks.

The progress of start-ups in their growth phase is at risk due to potential pitfalls associated with various factors. Illustrative fraud risks such as procurement fraud, construction fraud, expense manipulation, undisclosed related-party transactions, CSR misrepresentation, cyber fraud, and data leakage are complex issues that companies grapple with. Besides, risks triggered by misidentified or misrepresented KPIs, deviation from the identified business model, undisclosed liabilities, and excessive fund allotment to marketing, can have catastrophic repercussions on the functioning of the company.

Fraud risk varies across industries and is influenced by several factors. In sectors that involve monetary transactions, the threat of cyberattack looms large, but for sectors where a large amount of data is involved, the data processing and data privacy risks are manifold. While frauds such as the manipulation of books are commonplace across industries, consumer-facing companies also deal with a lot of vendor issues and KYC-related dilemmas. In industries where products are involved, there is a constant problem of counterfeiting or replacing with substandard material. These frauds can incur heavy financial and reputational damage for the company, making it critical to tighten the monitoring process to detect such incidents at an early stage.

Furthermore, here are some specific risks in industries with a flourishing start-up ecosystem.

01 Balancing innovation and regulation: the fintech paradigm

The post-pandemic surge in the fintech sector has led to a remarkable influx of innovative startups, showcasing the industry's resilience and adaptability. However, amidst this growth, challenges have surfaced that present opportunities for improvement rather than compromising the integrity of the sector. In the pursuit of success, fintech companies are learning valuable lessons about the importance of thorough Know Your Customer (KYC) processes. Recognizing the significance of complete KYC is a critical step towards establishing robust onboarding practices that will enhance customer due diligence in the long-term and improve credibility in the market.

Moreover, its critical to assess the authenticity of partnerships to ensure they are based on verified and transparent transactions. The focus on ethical conduct extends to regulatory compliance, with a shift towards building trust through adherence to guidelines rather than resorting to under-the-table practices. This evolution will contribute to a more positive governance framework, reducing the risk of reputational damage while enabling sustained growth in the sector.

02 Connecting the dots for e-commerce success

The e-commerce industry has been experiencing a surge in prominence with the rapid onset of extensive digitalization. However, like any sector, it faces challenges that need to be addressed for sustained growth. E-commerce companies must implement robust internal controls, conduct regular audits, and employ advanced data analytics to detect and prevent fraudulent activities. To enhance transparency, its important to establish clear guidelines on seller relationships and financial transactions and prioritize privacy concerns with stringent data protection measures to prevent unauthorized seller-customer interactions. These steps will not only mitigate risks but also contribute to building a trustworthy and sustainable e-commerce ecosystem.

03 Empowering consumers: ensuring trust in every transaction

The consumer sector faces significant challenges, including the prevalence of counterfeit products, insufficient controls to monitor product quality due to reliance on third-party associations, and irregular payments made to regulatory authorities to influence standards. To address these issues, industry stakeholders can implement stringent quality assurance protocols, enhance collaboration with reliable suppliers, and establish transparent payment procedures with regulatory bodies.

Implementing robust internal controls, conducting regular audits, and utilizing advanced analytics can help detect and prevent these manipulative practices. By adopting proactive measures, like improved quality monitoring, transparent payment practices, and enhanced financial oversight, start-ups can foster a more trustworthy and sustainable industry landscape. Addressing these challenges head-on will go a long way in building confidence among consumers and stakeholders alike.

04 Revamping the pulse: streamlining healthcare and manufacturing

The Healthcare sector witnessed a significant surge during the pandemic when many other industries were grappling with challenges. However, it is not immune to certain issues, such as phantom billing and upcoding. At the same time, the Manufacturing sector is currently contending with Good Manufacturing Practice (GMP) violations and off-label marketing, along with instances of consumer deception aimed at making insurance claims. Addressing these challenges will require wider implementation of effective monitoring mechanisms and compliance measures, fostering transparency in financial transactions, and promoting ethical practices across both the Healthcare and Manufacturing sectors.

05 EdTech leading the learning revolution

Similar to healthcare, the EdTech sector witnessed an unprecedented surge during the pandemic as students and professionals sought remote learning opportunities. In adapting to the new normal, EdTech companies are striving to compete with universities and institutions. However, this has led to loopholes in Know Your Customer (KYC) protocols, manipulation of tests and attendance records, lack of transparency, data manipulation etc.

Higher focus on ethical business practices, robust KYC verification processes, transparent communication with students, and adherence to fair competition standards is the need of the hour. Implementing measures to ensure accurate data representation and fostering an environment of integrity will contribute to the sector's sustainable growth in the evolving education landscape.

Chalking a blueprint for cultivating trust and honesty

Start-ups can build or strengthen their integrity and compliance framework by following an approach that lays equal emphasis on prevention, detection, and early response to emerging risks:

Prevent	Detect	Respond
Code of Conduct	Speaking up and confidential reporting	Incident and case management
Policies, procedures, processes, and controls	Third-party diligence	Investigation
Education and advice	Monitoring, reviews, and auditing	Corrective action
Incentives	Data analytics	Remediation

The requirements of each organization and situation may differ, which requires that the management curate their own integrity agenda based on their unique situation.

In the following sections, we have put together a sample integrity agenda for fund managers and investors as they manage their portfolios and evaluate potential investments, based on best practices we observed while working with many start-ups and investors in the country.

We have also outlined how an integrated approach to due diligence and vigilance by different shareholders could reduce the incidence of poor governance.

Fortifying trust: integrity drives our portfolio success

The requirements of portfolio companies will change based on their stage and scale of operations. As investors have seen multiple start-ups pass through these stages, they are in the best position to advise companies on the right way to build robust governance systems.

Prevent

Early stage:

The initial years set the tone for future growth of the company. Introducing strong policies at this stage will set the foundation for the company and future boards to build on. A few policies that can be introduced at this stage are:

MIS reporting schedule: Prompt reporting to the board and shareholders encourages financial discipline and investment in systems that can capture and analyze data quickly. Investors can provide inputs on key metrics, software tools that can help in such reporting, and the frequency of such metrics.

Statutory compliance monitoring: The appointment of an in-house compliance professional and regular tracking of compliance requirements will ensure there are no lapses that could harm the prospects of the company or result in fundraising and legal issues. Linking variable pay of Key Managerial Personnel (KMP) to timely compliance could also help in making this a priority. Regular reporting to the board will help in addressing lapses that may occur in relation to statutory compliance.

Policy on related party transactions: In the initial stages a company may need to rely on personal contacts and references of the key management. Introducing a policy on related party transactions (RPTs) will ensure such dealings are conducted with caution. This policy will cover the control and monitoring of RPTs, pricing policy, periodic review by audit committee/as part of internal audits, internal RPT disclosure policy, etc., for private companies that prescribe a lower threshold for effective regulation. This should be formulated taking into account the size of the company and the value of the transactions conducted in the regular course of business.

Growth stage:

With fast-growing companies, additional attention needs to be paid to the support functions that also need to keep pace with the scale of the business. Investors can guide these companies to plan for such requirements ahead of time:

Training programs for employees: As employee strength grows, it can be more difficult for the board or the key management to monitor all aspects of the business. Timely seminars and workshops aimed at making every employee an ambassador of good governance will be the first line of defence for any firm.

Financial team sufficiency: Having a Financial Controller at Series B and full time CFO at Series C stages will help the company maintain internal systems as needed. The auditors should also be selected keeping in mind the complexity and scale of the business, with the participation of all stakeholders.

Selection and remuneration policy: Attracting the right people is critical at the growth stage and a policy that ensures directors, officers, and employees are remunerated fairly, transparently, and aligned with the company's performance and objectives can go a long way in building the team. A selection policy should also be put in place to ensure that only candidates with required qualifications are appointed especially in terms of related parties getting appointed to office of profit.

Technology solutions: ERP and accounting solutions will need to be upgraded with time to deal with the complexity of an expanding business

Focused committees: Committees for internal complaints, audit, remuneration, CSR, etc., reporting to the Board can ensure better compliance with legal requirements.

Independent Directors: The appointment of Independent Directors, especially those who are also familiar with the specific business and market of the company, will add additional objectivity and support to the management team. The Independent Director can also head the audit committee for additional safeguards.

ESG policies and team: Appointing key management personnel in charge of ESG goals will help the company build strong plans and be internally motivated to build a firm that keeps all stakeholders' interest in mind.

Late stage, Pre-IPO:

Publicly traded companies have a significantly higher compliance requirement and it is advisable that companies planning an IPO in 2-3 years start building internal systems and processes as part of their governance strategy.

Forum for investor grievances: This means establishing a policy and a committee that will address and resolve investors', Grievances, provide them with the necessary information, and escalate the same to the Board, if required. The Companies Act 2013 now also mandates companies with more than 1,000 security holders to constitute a stakeholders relationship committee (which will focus solely on resolving security holders' grievances) comprising of a non-executive director as the chairman. Smaller companies too can adopt this to provide an effective platform to investors.

ESG reports and audits: Periodically publishing reports on the verified outcomes of ESG efforts is also an indicator that this is an area of active focus for the firm.

Detect

Early stage:

MIS reporting or audit closure delays: Weak internal reporting systems can convey a lack of transparency or lax approach. Delays in key reports should be investigated further for instant remediation.

Performance outliers and mismatches: Sudden changes in cash positions, receivables, discounts, etc., point towards unhealthy internal practices that can build over time. Similarly, any large differences between MIS and financial accounts also need to be verified.

Market sources: News coverage, customer sentiment, vendor feedback, employee attrition, etc., could also be leading indicators of trouble areas.

Growth stage:

Internal audits: Periodic reviews and audits by experienced external teams will reduce occurrence of slippages and ensure that objectivity is maintained in governance. Boards should encourage auditors to present their findings to the Board directly to enhance transparency and independence.

Key Managerial Personnel (KMP) due diligence: It could be a good practice to run short due diligence exercises to ensure that the team continues to maintain the high standards of integrity that they started out with and have not changed their stance due to the pressures of growth. Cordial relations between the founding team and KMPs will become more important as growth pressures and compensation packages build up.

Whistle-blower policy: A mechanism to anonymously report any unethical or illegal activities to the company management, or to investors, without fear of retaliation could help address concerns before they cause irreparable harm. This will have to be paired with a procedure to discreetly investigate and address the issues and report the conclusions to the Board.

Late stage, Pre-IPO

High attrition in compliance or finance team: A significant churn in the team could indicate concerns about the direction of the company or internal practices.

Board meeting process: Boards should ensure that the appropriate duration of notice is maintained before EGMs or AGMs, the complete agenda is shared beforehand, and all members are given an opportunity to attend and raise questions. A lapse in the process or a drop in transparency could indicate more serious concerns.

Rights of minority shareholders: As startups raise larger rounds, early investors tend to drop to insignificant stakes. A drop in transparency is usually felt first among these investors.

Respond

Response of the Board and investors to any negative incident will depend on the circumstance and severity, rather than the stage of the business. The following are some safeguards that investors can look at to respond adequately:

Investigation: A team responsible for investigation should ideally have representatives of different stakeholders who are not party to the incident and have some expertise in the area of concern. External teams may also be brought in depending on the situation.

Protecting the vulnerable: The team should keep in mind the party most impacted by such actions (such as customers or employees) and what can be done to mitigate any adverse impact on them.

Contractual rights: Investment documents usually have indemnity and termination provisions to hold the company and promoters responsible for any misdemeanor. Investors should try to ensure that they continue to have information and investigation and consultation rights, as a group, even if their stake falls below the threshold levels. This should include the right to be informed of a material adverse effect on the business, concerns raised by auditors, and the plan of action by the Board once an incident has been identified. Investors may also be asked contractually to share their findings, upon an audit/inspection, with other investors. They may also seek information relating to correspondence with statutory authorities/regulators which are not part of the ordinary course of business.

Similar to mandatory disclosures by listed companies on their website, private companies may determine the kind of disclosures possible to be made to all shareholders and the method in which this can be made. For instance, companies may look at disclosing certain key events/information on their website or a portal only accessible to the shareholders, for privacy concerns and such that minority shareholders have access to the same.

Team strength: Having a strong mid-level team will be necessary for damage control in case any key management personnel need to be investigated or suspended.

A well-planned robust system for prevention and early detection should minimize the need for response, but savvy investors are always prepared for the worst.

Due diligence anchored in integrity

When conducting due diligence on a potential investment, an investor is most concerned with stage II of the integrity agenda – detection.

The focus and need for due diligence changes according to the stage that the business is in. During earlier stages, there is less history or baggage to be verified, but at the same time, this is a critical stage to ensure that the founding team is putting in place the building blocks for strong governance in the future. The team conducting the due diligence needs to be more sensitive to finer points that could develop into issues later. Due diligence findings at this stage will inform investors and the board about critical red flags that need to be addressed and the areas that need more attention.

In the later stages, the team conducting due diligence will need expertise in separating signal from noise, as the important factors may be hidden in vast amounts of data. In addition to checking facts, they also need to check if the internal systems of the company are adequate for the scale of operations. As companies grow very quickly, it is easy to overlook some critical internal functions that need to be invested in to support the scale of operations.

The following is a checklist of due diligence action points for quick reference, depending on the stage of the company.

Early stage:

- Due diligence on the founders for integrity, technical competence, leadership factors etc.
- Understanding the dynamics between the founding members as well as relatives of the founders engaged in the company
- Market research on the industry, including common risks
- Related party transactions to be conducted with caution
- Mechanism of compliance control with hiring of professionals/company secretary, etc. as well as designation of compliance Officer.

Growth Stage

- Background checks on founders, KMP, and key third parties
- Interviews with customers, vendors, and past employees
- Technical due diligence on innovative products, especially in healthcare
- KPI and MIS reviews to look for anomalies as compared to the market and to the company's own past records
- Social media and ecommerce analytics, where applicable
- Review of finance, accounts, and compliance team size and capacity
- Review of statutory compliance and timelines of filings since inception
- Internal policies on key governance issues, ESG, code of conduct, remuneration, etc

Late stage, Pre-IPO

- Complete forensic due diligence, especially in regulated sectors
- Integrity due diligences covering transaction forensics and Anti-Bribery and Anti-Corruption (ABAC) reviews
- Field research on key customers and vendors
- Setting up/assessment of compliance framework
- IPO readiness assessment
- ESG frameworks

Synergizing success: the integrated due diligence revolution

Identifying risks and opportunities related to potential mergers, acquisitions, or potential ventures is key to averting fraud in the long run. An integrated due diligence mechanism takes a multifaceted approach involving the evaluation of several aspects—financial, legal, operational, social, and environmental factors—to present a holistic picture of what is to be expected. This can help companies make informed decisions that will play a pivotal role in fraud mitigation and ensure sustainable growth.

Quality and integrity matters

Issues

- Business practices and operations
- Credibility/conflict of interests/KMP background
- Irregularities and malpractices in customer, vendor, and employee-related matters

Diligence approach

- Third party evidence
- Substantive procedures
- Secondary research/Field Forensics/Mystery shopping

Financials and historical performance

Issues

- Reliability of financial statements including reconciliation gaps with statutory filings
- Historical operating performance: Revenue, margins along with KPIs etc (applicable for growth-stage company)
- Control gaps in terms of financial reporting and compliance

Due diligence approach

- Historical information analysis including substantive procedures
- Forensic procedures / Data analytics and tracing with external evidence (select areas)

Balance sheet

Issues

- Incorrect reporting of debt and cash position
- Commitments and off-balance sheet liabilities
- Contingent liabilities
- Tax litigations and outgo
- Financial irregularities

Diligence approach

- Understand balance sheet liabilities
- Understand off-balance sheet liabilities/market research to understand the financial viability of the business
- Secondary research/Field Forensics/Mystery shopping

Integration process

- Findings from financial due diligence (FDD) to define the approach of integrity due diligence
- Cross-validation of findings and exchange of information
- Combination of findings of FDD and integrity due diligence work procedures

Importance of strong governance frameworks in the VC ecosystem

Corporate governance stands on three pillars - founder mindset, investor mindset and Board members

Startups, often characterized by their innovative spirit and dynamic nature, are susceptible to a plethora of risks ranging from operational and financial challenges to reputational threats. In the volatile world of entrepreneurship, maintaining the trust of investors, clients, and employees is paramount. Therefore, after formal due diligence, analysis and checking the capability of team, business model, PMF, valuation, need of funding and its deployment, etc., when investors finally trust a startup enough to invest, the founders must understand that it is their fiduciary responsibility to deploy the capital diligently and as agreed upon with investors.

Yes, pivots happen all the time, but a healthy 'start-up founder-VC investor' relationship, built on a foundation of efficient and timely reporting, self installed checks and internal reporting, i.e. ensuring good governance practices, can lead to not just exemplary corporate culture but also be a road to creating a successful business empire. A robust governance framework plays a pivotal role in establishing and upholding ethical standards, transparent decision-making, and accountability.

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In the vibrant world of Indian startups, success orbits around the founder's mindset, investor strategies and board dynamics. Navigating the entrepreneurial roller coaster demands more than a mere governance formality—it's a strategic imperative. Timely reporting, internal checks, ethical benchmarks aren't just corporate niceties; they form the bedrock of a flourishing startup culture, fostering collaboration, trust and sustained growth. Profitability, unit economics, robust governance aren't mere features; they are the formidable pillars on which every startup thrives. This emphasizes governance's pivotal role in steering risks, luring investments and ensuring enduring growth in the ever-evolving startup landscape.

Amit Pandey

Vice President, IVCA

Navigating Risk through Governance

Startups, initially grappling with limited resources and inexperience, must understand that embracing good governance is a journey that begins early. As startups grow and evolve, their governance needs expand, underscoring the importance of proactively establishing a culture of responsible governance from the outset. Effective corporate governance practices help in implementing internal controls, risk management systems, vigilant monitoring, and aid in the identification, assessment, mitigation of these risks.

Fostering Collaboration and Trust

PEs/VCs are vital players in the startup ecosystem. There are several scenarios that can lead to governance lapse as highlighted in the report, thus strong governance practices provide a framework for better communication, streamlined decision-making, for running a company successfully, maintaining robust relationships with investors and organising productive board meetings. These elements are essential for the long-term sustainability of startups.

Investors' money comes with a ticking clock, as General Partners of VC/PE funds have to return the capital with profits to their Limited Partners in a time bound manner. A founder should be well aware of this and understand that profitability, unit economics, good governance standards are not just features of a successful business but act as strong pillars on which the whole operation runs.

The Core of Corporate Governance

Corporate governance is more than just a set of rules; it begins with a company's core beliefs and values. Over time, it evolves into a framework of principles, processes, and practices that oversee the management and control of the organization. This includes aspects like ownership structure, decision-making processes, and adherence to legal and regulatory requirements. The Indian government is also taking steps to strengthen corporate governance through various committees and regulations, notably the Companies Act, 2013. Promoting good governance practices has become critical to foster a sustainable business environment.

Conclusion

Good corporate governance is based on founder mindset, investor mindset and board members. At the same time, a startup must create a culture where independent directors can speak openly and any red flag or word of caution by the auditors is acted upon immediately. All stakeholders are equally important for a startup and founders must build efficient stakeholder management practices, be it sensibly thinking about diversity and inclusion, climate or even the customer complaints for that matter.

Despite the resource constraints and unique challenges they face, startups must prioritize corporate governance to maintain integrity, which in turn can attract investments, and foster sustainable growth.

Harnessing internal audits for proactive risk detection

Through systemic evaluation of internal controls, operational procedures, and financial reports, internal audits reveal potential vulnerabilities and assess the impact of a risk. This proactive approach helps companies tackle fraud risks and ensure complete compliance with regulations.

Risks addressed in internal audit (current model)

- Compliance risks associated with income tax, GST, and returns filing
- Financial risks associated with revenue and asset accounting, financial reporting
- Procurement
- Bank reconciliations
- Payroll
- Asset management

Internal Audit 2.0 (aspirational model)

- Overstatement of financial and operational metrics - GMV and user base inflation
- Illegal activities on the tech platform
- Business operations risks such as AML, cyber, related parties
- Fraud risks such as siphoning of funds
- Bribery and corruption

Suggested areas to be integrated with traditional audits

01 Benchmark MIS

02 Perform technology audits on tech-based platforms

03 Integrate financial audit with technology audits

04 Cyber risk reviews such as VAPT, Info Security

Crafting an internal audit framework that's right for you

Understand the portfolio mix of the VC/PE and perform a risk analysis of the portfolio based on the following indicative factors:

- Size of the business
- Industry and demography in which it operates
- Present perceived maturity of compliance, governance, and internal controls
- Investments in which funds have been identified as important
- Maturity of the company

Categorize companies based on the risk framework to be critical for internal audits

Prepare a risk-based internal audit plan for a set of portfolio companies:

- Periodic internal audit for each category of company
- Scope and coverage of internal audits
- Reporting findings to stakeholders
- Recommendations and remediation plans for gaps identified in specific companies

Regulatory framework of corporate governance

Companies Act, 2013 and rules thereunder

While the Companies Act, 2013 and rules thereunder provide for compliances based on the nature (public/private) and size of the company, and are subject to certain thresholds, these provisions can be applied to all companies since they are protective in nature and act as a fillip to effective corporate governance.

Based on the provisions of the Companies Act, 2013, companies can deploy the following measures for effective corporate governance:

- Appointment of independent directors will ensure separation of power from the promoter group/management. This will also help in creating another layer of fiduciary duty towards matters relating to the company.
- Appointment of Independent directors also helps in attracting individuals who have sectoral expertise, which results in effective functioning of the Board of Directors.
- Constitution of Board committees such as internal complaints committee, audit committee, remuneration committee, CSR committee (regardless of whether they meet prescribed thresholds) will help in monitoring compliance with applicable laws and will ensure escalation to the board in case of any potential contravention/irregularity.
- Requirement of board and shareholder approvals for related party transactions will ensure that these are undertaken with caution and in accordance with law. Companies may formulate an internal policy which can prescribe lower thresholds than those prescribed under the Companies Act, 2013 and rules thereunder. This will ensure effective monitoring of such transactions.
- The statutory auditor must be periodically replaced to ensure that one auditor is not entrenched in a company, and the company's accounts are subjected to fresh reviews with each new appointment. Periodic replacement of the auditor helps in facilitating a more independent and objective audit exercise of the company's affairs. Further, appointment of an auditor should be undertaken with participation of all stakeholders.
- Companies Act, 2013 provides for annual as well as occasional specific disclosures by directors, spanning matters related to the operations of the company, their parallel interests in other entities, material changes to the financial position of the company, their disqualification, if any, etc. This reporting mechanism helps provide visibility to all stakeholders.

Regulations by SEBI (including the LODR regulations):

While these regulations are mandated for publicly listed companies, they can be adopted by close-knit companies too for effective corporate governance.

- Requirement of board as well as shareholders' approval for remuneration (including any stock options) of founders/key managerial personnel, such that it is based on objective performance criteria.
- Requirement of an audit committee, as elaborated above, specifically provides for a transparent, effective anti-fraud and risk management mechanism and regulates financial reporting. In order to limit the control of Executive Directors' influence over the audit committee, an Independent Director, as a head of audit committee, should be entrusted with the responsibility to maintain transparency and accuracy during audit process, disclosure of information, and financial reporting.

- The business operations of a company can be carried out effectively by ensuring that the business plan and the allied annual budget for the same are reckoned with board approval with the presence of nominee directors appointed by the investors. Any key departure from these should require disclosure of relevant information which, in turn, will trigger a discussion among stakeholders. This provides for efficient monitoring/vigil mechanism and reduces excessive dependency on promoters.

- Formulation of a code of conduct, which should also be uploaded on the company's website, will instill ethical practices within the company. It will encourage whistle-blowers to report any irregularities or violations. This will ensure that the board corrects their course and remediates such irregularities/violations as soon as they emerge.

- These regulations also prescribe the duties of the board for monitoring governance practices, reviewing and guiding corporate strategy, risk policy, annual budgets and business plans, setting performance objectives, monitoring implementation and corporate performance, following ethical practices for accounting policies and financial reporting, etc., which can be adopted by closely held companies in order to stimulate a sound corporate governance framework.

National Guidelines on Responsible Business Conduct:

These guidelines set out the basic principles for doing business in India (regardless of the size, sector, entity, or ownership of the business), with its core principles revolving around: (i) conducting business with integrity; (ii) promoting sustainable growth and employee welfare; and (iii) protecting the environment. These guidelines draw inspiration from UN's Sustainable Development Goals and the United Nations Guiding Principles. These guidelines consist of the following:

- Business Responsibility Reporting Framework, which serves as a format for reporting and providing periodic information to different stakeholders

- Emphasis on ethics for governance structure, transparent communication, and sufficient disclosures

- Emphasis on efficient solutions to reduce carbon footprint and minimize impact on the environment

- Emphasis on employee welfare and security and upgradation of their skill while ensuring compliance with labor laws

- Focus on collective development whereby businesses have a positive impact on the geography within which they operate

Effective manner of conducting board and shareholder meetings:

- Participation of stakeholders ensures that the company is being governed and operated effectively. Such participation can be ensured by providing a timely notice for a meeting of the Board of Directors or the shareholders, as may be applicable. Even if the meeting is proposed to be held at shorter notice, the duration of the notice should be determined keeping in mind the agenda for the meeting, the matrix of stakeholders involved and the size of the company. Further, such notice should also include relevant information for the agenda of the meeting such that the stakeholders can effectively participate in the decision-making.

- While the Companies Act, 2013 allows for meetings of the Board as well as that of shareholders to be held virtually, companies should insist upon holding physical meetings to the extent possible. This encourages effective participation among the stakeholders where they can deliberate upon the agenda in greater detail. This also obviates any technical issues that participants may face due to improper network connectivity. It facilitates improved engagement,which is limited in a virtual set-up.

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