# Foundations of governance: Building a solid framework for start-ups and investing partners

**Board Leadership Center (India)**

In the last decade, India has emerged as one of the fastest-growing 'start-up nations' in the world, boasting over 98,000 start-ups, 400+ incubators, and 108+ unicorns[1]. While these start-ups are contributing significantly to the country's socio-economic growth and garnering international recognition, there has also been a surge in instances of corporate missteps and ethical lapses.

In a quest for innovation and rapid expansion, start-ups often find themselves amidst a unique set of challenges and pitfalls, resulting in corporate failures. Such failures not only disrupt the internal dynamics of the company but reverberate through the entire ecosystem, affecting stakeholders, investors, and the industry at large, underscoring the critical need for a robust governance framework.

## Corporate governance – the building blocks

In today's dynamic landscape of business world, where start-ups are emerging as key players in innovation and disruption, the significance of robust corporate governance cannot be overstated. As the foundation upon which organisational integrity is built, effective governance practices serve as guiding principles that can steer start-ups towards sustainable growth and success. By prioritising honesty, transparency, and accountability from the outset, start-ups can instill confidence among investors, attract top talent, and foster strong partnerships with stakeholders. Moreover, implementing governance norms early in the start-up journey not only helps mitigate risks and enhance decision-making processes but also sets the stage for long-term value creation and resilience. In a competitive environment where reputation and trust are invaluable assets, embracing good corporate governance is not just a choice—it's a strategic imperative that can pave the way for enduring success and prosperity.

While there is a conceivable risk that adherence to the governance norms could escalate costs and/or stifle innovative thinking, it is possible to mitigate this risk by balancing governance with a culture of innovation and regularly reviewing and updating governance frameworks. The overall benefits far exceed the possible downsides.

### Some key benefits of introducing governance norms early in a start-up

- Enhanced accountability
- Improved decision-making
- Reduced risk
- Increased access to capital and partnership
- Stronger reputation

[1]View: Startups should recognise the importance of corporate governance, self-regulation, The Economic Times, Jun 2023.

## Key challenges faced by start-ups in implementing strong governance

**Limited resources:** Start-ups often face resources constraints, including limited financial resources, manpower and time. Allocating resources towards establishing and implementing robust governance practices may not be a top priority, especially in the early stage when focus is on product development

**Conflict of interests within the board:** Governance challenges arise when a company is jointly owned, blurring the line between personal interests of founders, executives, and stakeholders. Balancing personal interests with company objectives requires transparent policies and effective governance mechanisms

**Optimising investor support:** When investors are involved in too many startups simultaneously, their attention and resources become thinly spread, hindering their ability to provide adequate guidance and support. Careful consideration of investors' commitments is necessary to ensure optimal support for startup success

**Dual fiduciary duties:** Venture Capital (VC) and Private Equity (PE) investors face dual fiduciary duties of seeking returns for their funds while fostering the best interests of the start-up. Balancing these conflicting duties requires clear communication, transparent policies, and collaborative decision-making

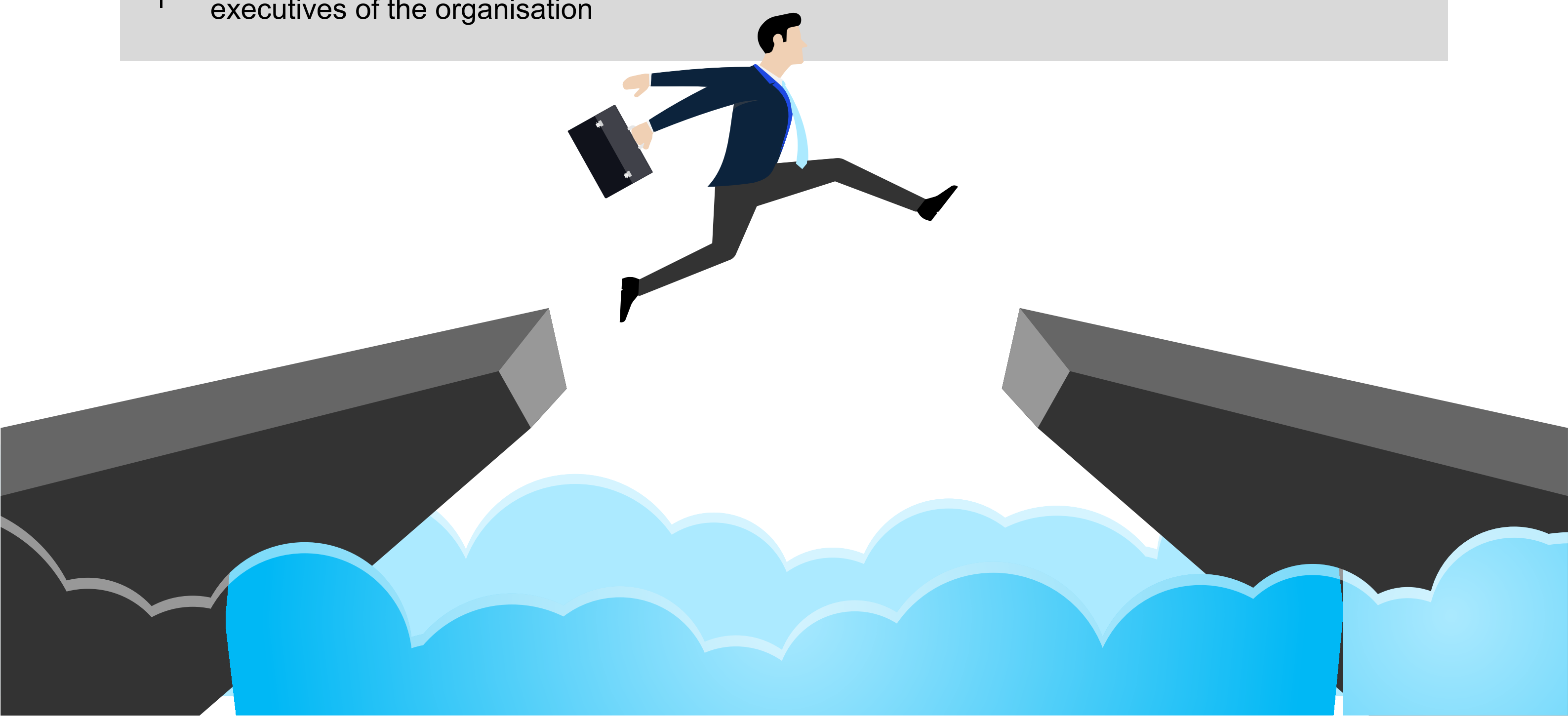
**Economic situation:** The implementation of an effective governance framework is influenced by the stage of growth and board dynamics, especially in different economic conditions. During favourable conditions, founders have significant influence, while during downturns, investing partners play a disciplinary role, encouraging the adoption of governance practices.

## How can the investor firms contribute to enhance governance?

- **Establishing empowered boards:** In start-ups, where founders often take on the role of CEO, establishing an empowered board is crucial for ensuring effective decision-making and sustainable growth. Investor firms play a pivotal role in shaping the composition of these boards, strategically selecting individuals with diverse expertise and independent perspectives. By instating small, highly skilled boards with adequate representation from seasoned outsiders, investor firms can ensure that critical decisions and reward systems are made with careful consideration and impartiality. This approach not only enhances corporate governance but also fosters a culture of accountability and transparency, setting the stage for long-term success in the competitive start-up ecosystem
- **Strategic advisory role to the portfolio company:** Investor firms can utilise industry expertise and networks to advise portfolio companies effectively, adding value to governance roles and increasing impact
- **Capacity building of the management and employees:** The investor firms can facilitate training programmes and workshops for the start-ups in their portfolio to enhance the understanding of executives and board members regarding governance principles and practices
- **Regular audits and assessments:** Conducting regular audits helps in monitoring effectiveness of governance frameworks, identifying areas for improvement and leveraging key mechanisms.

### Red flags to be cautious about while investing…

- Inconsistent financial reporting or consistent financial irregularities in the financial statements of the start-up
- Reluctance by organisation's board in sharing relevant information with the investment team
- Presence of a high turnover among top executives of the organisation
- Past infamous records for regulatory violations or legal disputes by the start-up
- A frequent conflict of interests within the board members and inability to reach a decision effectively



## An indicative governance framework for start-ups

The spectrum of companies within India's start-up ecosystem displays diversity, with each company exhibiting unique characteristics in terms of size and intricacy. As each company demands a tailored strategy, there's no one-size-fits-all approach that's applicable to all the companies.

However, we have aligned the essential governance practices required at each developmental phase, enabling the owners, and investing companies to effectively gauge the company and pinpoint the relevant practices. While flexibility is possible in initial stages, the recommendations outlined here serve as fundamental prerequisites for every leg of a start-up's progression.

| Stage | Good governance practices |
|---|---|
| **Seed stage** | • Board establishment and functioning in accordance with applicable prevailing law<br>• Appointing a member to oversee the finance function, adopting accounting policies and consistently applying them<br>• Appointing a competent audit firm<br>• Awareness on statutory and regulatory compliance requirements for smooth functioning |
| **Early stage Series A and B** | • Expanded board role with investor nominees covering governance and financial reporting matters<br>• Approval by board for delegation of responsibilities<br>• Appointment of a full-time HOF/Finance controller with skilled teams to oversee finance and account functions<br>• Implementing a whistleblower programme and spreading awareness regarding it through sessions<br>• Key business metrics as a part of MIS<br>• Appointment of a leader for secretarial function<br>• Tracking of related-party transactions and making necessary disclosures |
| **Growth stage Series C and D** | • Fully functioning board including addition of non-independent directors with unique skills or to play an advisory role<br>• Appoint a tier-1 internal and statutory audit firm with expertise in relevant industry<br>• In-house secretarial function and investment in building systems and processes to maintain compliance<br>• Separate risk sub-group to oversee risk management<br>• CFO to prepare annual forecasting and track actual against the predicted<br>• Establishing anti-fraud programme covering key areas of finance, sales, and procurement<br>• Delegation of powers, defined and approved by the board<br>• Establishing a compensation sub-group responsible for evaluating and recommending senior leadership compensation structures |
| **Mature stage Pre IPO** | • Benchmarking board composition and compliance requirements against public listing norms<br>• Formation of mandatory and good-to-have board committees as required under regulatory acts<br>• Establishing a clear roadmap for IPO readiness<br>• Appointment of an Independent Audit Committee Chair<br>• Segregation of duties of CEO and Chairperson<br>• Periodic exercises to test the effectiveness of the business continuity plan<br>• Incorporate shareholder communication mechanism<br>• Monitoring of related-party transactions<br>• Organisation's purpose and values for cultural development |

# Key considerations

## For owners/executives

- How transparent are our financial reporting processes? What measures have we taken to ensure accurate and timely disclosure?
- Have we identified and assessed potential risks, and do we have effective risk management framework in place?
- What strategies are in place to mitigate identified risks and ensure future protection?
- How do we ensure responsible handling of data within the organisation, considering data privacy laws in the country?
- How are we managing and protecting our intellectual property? Do we have clear policies for IP governance?
- How diverse is our board in terms of skills, backgrounds, and perspectives?
- How do we monitor and enforce compliance within the organisation?
- Do we have a succession plan for key leadership positions, including the CEO and board members?
- What areas of governance require improvement or strengthening?
- Do we have mechanisms for internal and external auditing to maintain integrity?
- How do we engage with stakeholders and build trust and credibility?
- Are we compliant with relevant laws, regulations, and industry standards?

## For investing partners

- Have we conducted thorough due diligence to ensure compliance with Indian regulatory requirements?
- How can we optimise the board structure for start-ups to ensure independence and diverse expertise?
- Is the existing board transparent in communication and reporting? What mechanisms are in place to ensure accurate and timely disclosure of information?
- What is the start-up's governance track record, and how does it align with our standards?
- How does the organisation prioritise ethical practices and integrity within its operations?
- What measures are in place for identifying and managing potential risks? How effective is the risk management framework?
- What is the start-up’s current financial health and how disciplined are the financial management practices?
- To what extent does the organisation incorporate ESG principles, and how aligned are they with our ESG goals?
- How are investor rights protected, ensuring a fair and transparent relationship?
- How frequently does the company communicate with shareholders?
- What are the start-up's exit plans, and how can investing partners ensure a smooth transition while maintaining corporate governance standards?
- What valuation metrics are considered for potential exit?
- To what extent does the company focus on long-term sustainability, and how is this reflected in its governance practices?

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