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E - JOURNAL OF FRTL @ IIM CALCUTTA

March 2024, Volume 11, Issue 4

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

INDIAN INSTITUTE OF MANAGEMENT CALCUTTA

FRTl

Financial Research & Trading Laboratory

Start-Up Governance – Is It Time to Put an End to 'Fake It till You Make It'?

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Abstract

The past few years have witnessed a change in the start-up landscape of India. The year 2021 saw an exceptional surge in the number of unicorns. A few unicorns also went public. Government initiatives like Start-up India, Make in India, and Digital India have given further fillip to the wave of entrepreneurship and start-ups in India. Start-ups have contributed to employment generation and economic growth. However, the tremendous growth is coupled with ethical and governance issues. Instances of success stories of start-ups tainted with unethical practices and mismanagement are well-known. It is important to ensure that start-ups do not resort to undesirable practices to achieve/showcase growth. As the start-up landscape is growing and evolving in India, there is a need to strike a balance between incentives to promote start-ups and regulatory architecture for start-ups. The start-up ecosystem requires proper regulatory architecture to ensure that growth is not at the cost of governance and ethical considerations. This step is timely and in the interests of all the stakeholders.

1. Introduction

India is emerging as one of the prominent start-up ecosystems in the world. It has witnessed unprecedented growth in the number of start-ups (figure 1). As of February 2023, the number of start-ups officially recognized by the Department for Promotion of Industry and Internal Trade (DPIIT) is 1,23,864[8]. As per the Ministry of Commerce and Industry (DPIIT), a start-up is defined as an entity with an age of 10 years or less from the date of incorporation and; a turnover of less than Rs. One billion in any of the financial years from the date of incorporation; and is engaged in *innovation, development or improvement of product, processes, or service*[9]. *It also includes a scalable business model with a high potential for employment generation or wealth creation*[2].

[8] https://www.startupindia.gov.in/content/sih/en/startup-scheme.html accessed on 13-3-24

[9] https://dpiit.gov.in/sites/default/files/notification_Definition_StartupIndia_06July2021.pdf

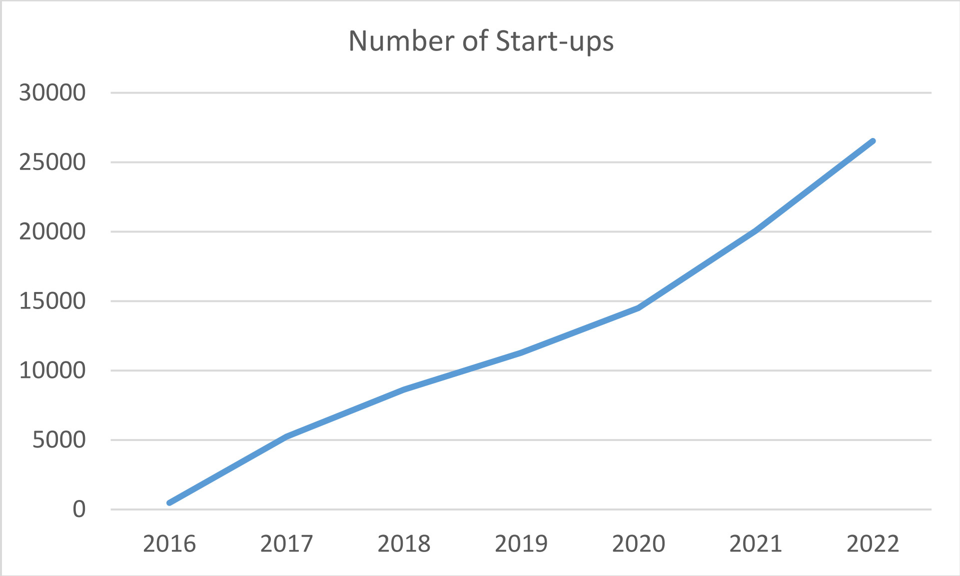

Figure 1: Number of Start-Ups in India
Source: https://www.statista.com/statistics/1155602/india-start-up-recognized-businesses/

Several factors such as easy access to funds, a skilled workforce, robust infrastructure, government support, and an enabling business environment have propelled the growth of start-ups in India. The Start-up India, Make in India, and Digital India initiatives by the Government of India have further cemented the growth of the start-up ecosystem by providing tax incentives, and access to capital, incubators, and accelerators. These incentives have not only acted as a catalyst for the growth of start-ups but also for the generation of employment (figure 2).

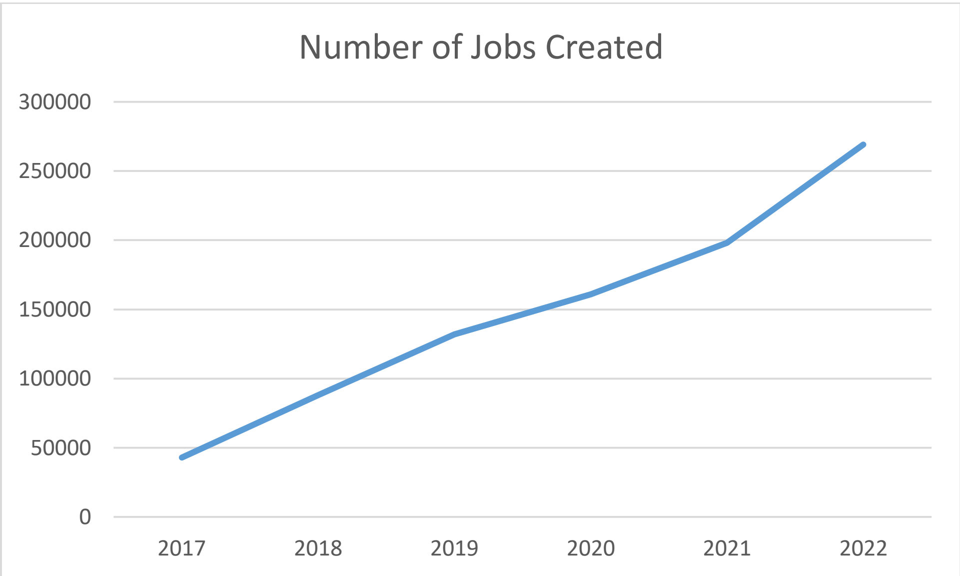

Figure 2: Number of Jobs Created by DPIIT Recognized Start-ups
Source: Economic survey 2022-23 (total number of jobs created (self-reported) by DPIIT recognized start-ups)

The conducive environment has stimulated the confidence of investors. India is viewed as one of the preferred destinations for investment. Indian Startups have witnessed a surge in valuations and unicorn status (figure 3). Start-ups with a valuation of more than one billion dollars are termed as unicorns. However, after an unprecedented increase in the year 2021, there has been a decline. The year 2023 witnessed only two unicorns – Zepto and InCred Finance[10]. Since 2021, a few unicorns have gone public – Zomato, Nykaa, Paytm, MamaEarth, Delhivery etc.

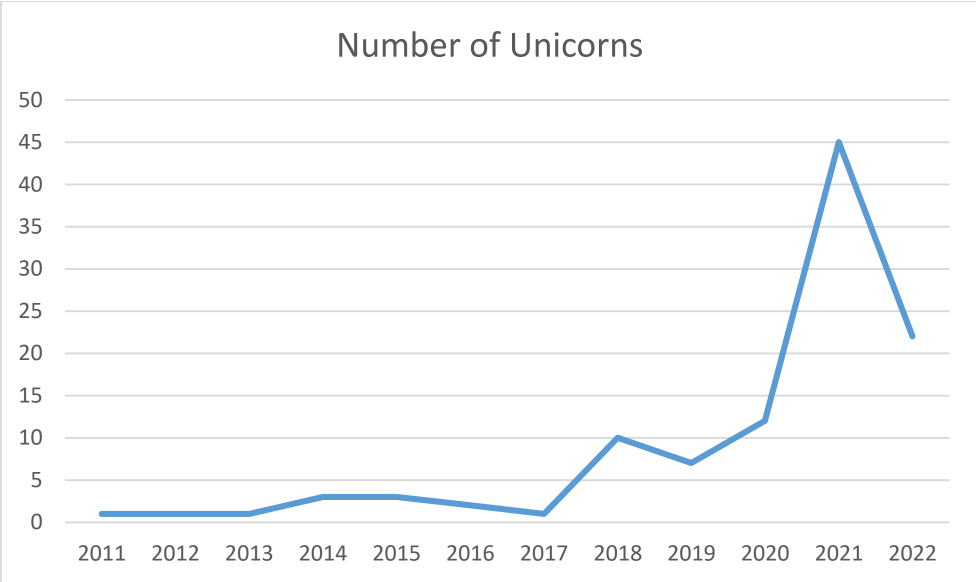

Figure 3: Number of Unicorn Start-ups in India
Source: https://inc42.com/the-indian-unicorn-tracker/

Unicorn status is viewed as a status symbol in the investing community. It attracts attention from investors, industry, and media. It also augments the reputational capital of the existing venture capital investors. However, on the flip side, it also increases the pressure to consistently grow, meet expectations, increase revenue, increase customers, scale operations, raise funds, break even, and become profitable. Owing to the pressure, the start-ups might resort to undesirable business practices to showcase a rosy picture. They take the route of *'Fake It till You Make It'*. The situation appears bleak once you view this rosy picture closely through the lens of governance and ethics. Instances at BYJU's, WeWork etc. underscores the need for relooking at the regulatory architecture for start-ups, specifically in terms of governance and ethics.

2. Need for start-up governance

The genesis of governance issues in any organisation is the conflict of interest between two or more interested parties. As Jensen and Meckling (1976) explain all the interested parties in any organisation are utility maximizers. When one party tries to maximize its utility at the cost of the other party, a conflict of interest

[10] https://www.ventureintelligence.com/Indian-Unicorn-Tracker.php

arises. To resolve and mitigate these conflicting interests, oversight and monitoring becomes important. This has resulted in different governance mechanisms to protect the interests of either party. However, the role of governance mechanisms extends beyond oversight and monitoring to provide strategic direction and guide decision-making. Good governance rests on pillars of transparency, stewardship, accountability, ethics, and integrity.

The financing structure of an entity and division of managerial control and decision-making define the governance mechanisms and their effectiveness. In the case of listed widely held corporations, the financing structure is primarily debt and equity. Equity is the prominent source of financing. Equity holders are the owners of the corporation. The managerial control and decision-making are in the hands of managers and they act as agents of owners.

The seminal work on governance by Jensen and Meckling (1976), and Fama and Jensen (1983a, 1983b) focus on widely held corporations. Such corporations have conflicting interests between owners/shareholders and managers. Managers act on behalf of owners and might make decisions which are not in the best interests of shareholders to maximize their gains. Information asymmetry also arises in such situations. In the extant literature, it is referred to as agency problems. To mitigate these problems, reduce information asymmetry, and enhance transparency, several governance mechanisms are used. Governance mechanisms consist of internal as well as external mechanisms (Cohen et al., 2004). Internal governance mechanisms include the board of directors and its sub-committees while external mechanisms include auditors, takeover market, and regulations. Moreover, these corporations are subject to listing requirements, regulations for publicly held companies, scrutiny of regulators etc.

However, in the case of a start-up, the prominent financing source is venture capital (VC) investment or owner's investment. Managerial control and decision-making rest with owners. Thus, the two main interested parties in a start-up are the owner/founder and VC investors. Governance issues in start-ups arise from conflicts of interest between founders and VC investors. Start-ups are unlisted entities and subject to less stringent requirements than listed entities as far as governance and disclosure aspects are concerned. Some start-ups are larger than many listed companies in terms of valuation and size. Thus, effective governance and disclosure become even more crucial.

3. Case of BYJU's

BYJU was considered the poster child of Indian start-ups. It is registered as Think and Learn Pvt. Ltd. It was one of the fastest-growing EdTech start-ups and the first unicorn in the EdTech space. The pandemic propelled its rapid expansion. In 2022, its valuation surged to $22 billion. However, the year 2023 shows a different story altogether. BYJU's faced backlash from auditors and investors. Consequently, its valuation and popularity declined. The issues concerning BYJU are used as a reference to highlight the need for governance mechanisms to ensure proper oversight, monitoring, and direction of start-ups.

[11]**Accounting policies:** In FY 2021, BYJU' suffered a loss of Rs. 4564 crore and a decline in revenues by 3.3%. The company said the reason for the decline in revenue is due to a change in the revenue recognition policy. This new policy has resulted in deferment of 40% of revenues to the subsequent years.

[12]**Auditors:** Deloitte Haskins and Sells LLP was BYJU's auditor. Deloitte – one of the Big 4's resigned as the auditor of BYJU citing the delay in accessing documents and financial statements necessary to complete the audit. It clearly stated that this delay impacted its ability to assess books of accounts. The resignation was triggered by a delay in presenting and filing the financial statements. As per the Companies Act of 2013, the audited financial statements should be presented in the annual general meeting to the shareholders by September (for the financial year ending in March). The auditor's resignation during the ongoing term is viewed as a red flag by the stakeholders. Such instances raise questions about the credibility of the company. Subsequently, MSKA & Associates was appointed as the new auditor. In addition to this, there has been speculation on the company's ability to continue as a going concern.

Analysis: One of the primary pillars of governance is transparency. Financial statements are one of the primary sources of information. It helps in evaluating the financial performance of an entity. It is a means of reducing information asymmetry between founders and VC investors. The credibility of financial statements depends on the auditor's opinion on financial statements. Hence, auditor and auditing requirements are one of the key governance mechanisms. The auditor's resignation during the ongoing term and qualified opinion should be viewed as a red flag. Such actions by auditors are generally to safeguard their credibility. It is vital to stress start-ups to abide by auditing requirements.

Board and Key Investors' Activism: The board and key investors play an important role in any entity. BYJU's board members representing investors such as Sequoia Capital India, Naspers Ventures, and Chan-Zuckerberg Initiative had quit the board[13]. They cited dissatisfaction with the audit, internal controls and processes, compliance, transparency, governance, financial management, and disregard of their advice as

[11] https://indianexpress.com/article/business/companies/byjus-auditor-quits-amid-mounting-financial-worries-8680682/

[12] https://www.bbc.com/news/world-asia-india-66126095

[13] https://www.reuters.com/technology/three-board-members-indias-byjus-step-down-sources-2023-06-22/

reasons to quit[14]. Investors have also marked down the valuation of BYJU's. Apart from this, inquiries from the Enforcement Directorate for violations of the Foreign Exchange Management Act, the Ministry of Corporate Affairs, and disputes with lenders have further exacerbated the situation. Investors have voted for leadership change in extraordinary general meetings, while the founders say investors do not have the right to change management. The tussle between founders and investors is going on.

Analysis: The resignation of key investors from the board is also viewed as a red flag. It is also perceived as a move to protect investors' credibility, lack of confidence in the management of the company, governance and compliance issues, mismanagement, ethical dilemmas, and differences of opinions. Whatever might be the reason, the market views such instances negatively. It puts the company under scrutiny and bad light. Ideally, the board is responsible for oversight, monitoring, and strategic guidance to protect the interests of investors. In the case of start-ups, the investors are generally few but the stakes are substantial. VCs also intend to guide the founders to grow the business sustainably and ultimately go public. BYJU's case does highlight the efforts of key investors and their activism. Though founders and investors have hurled allegations against each other and every coin has two sides, the role of investors and board in governance cannot be undermined.

[8] Business Strategies and Management: BYJU saw the pandemic as an opportunity to promote online education. It engaged in rapid expansion by aggressively acquiring start-ups in India and overseas. It spent approximately $ 2 billion to acquire Aakash, WhiteHat Jr, Toppr, Great Learning and Epic[15]. This has led to issues in integrating different platforms. They resorted to aggressive marketing strategies such as sponsoring major events and onboarding celebrities for endorsements. They acquired sponsorship rights for the Indian cricket team. Football icon Lionel Messi was signed as a global ambassador for their social impact initiative 'Education for All'. Heavy marketing spending when the company laid off a large number of employees has not gone well with the public at large. BYJU faced difficulty in paying salaries to employees. The situation reached a point where the founders had to mortgage their personal properties to meet the salary expense. It also defaulted on dues to lenders. Investors are also concerned about the revenue model dependent heavily on subscription-based services.

Analysis: Strategies and management of a company should be guided by taking into consideration the interests of key stakeholders. According more importance to discretionary expenses, the cost of statutory dues,

[14] https://www.wionews.com/business-economy/prosus-led-shareholders-push-forleadership-change-at-byjus-report-686236

[15]https://www.bbc.com/news/world-asia-india-66126095

employee salaries, and interest payments is contradicting in nature. Resorting to strategies to manage the top line is not sustainable in the long term.

[16,17,18]**Employees, Customers and Lenders:** There have been allegations of toxic work culture and undue pressure for acquiring more and more customers against BYJU's. BYJU have also faced inquiries for non-payment of provident fund money to the employees. Key managerial personnel like the chief financial officer and chief technology officer have also resigned from the company. It also engaged in mass layoffs. There have been allegations regarding mis-selling of courses and undesirable practices by parents. BYJU also defaulted on payment of dues to Google and Facebook for Ads and faced suspension. Lenders in the US have sued them and filed insolvency petitions. Investors and lenders also raised concerns regarding the conversion of loan to equity by Mr Pai at a lower valuation[19].

Analysis: The scope of governance is not limited to investors. Governance mechanisms need to ensure that the interests of other key stakeholders such as employees, customers, and lenders are safeguarded. Activities resulting in the expropriation of employees, customers, and lenders need equal attention.

The above instances reflect the grave situation at BYJU. It is evident that intentionally or unintentionally the key stakeholders had to suffer due to financial mismanagement, liquidity crunch, and governance and compliance issues. BYJU has decided to come up with a rights issue to deal with financial constraints. They are also considering establishing an advisory committee comprising independent directors to guide the management on board composition and governance.

4. Case of Zomato[20]

Zomato – a food delivery and restaurant search app was accorded unicorn status in February 2018. It was listed on the stock exchange in July 2021. Zomato provides a good case to evaluate a start-up which went

[16] https://www.ndtv.com/business-news/byjus-unraveled-the-meteoric-rise-and-staggering-fall-of-ed-tech-titan-500360

[17] https://www.moneycontrol.com/news/trends/byju-raveendran-byjus-saw-my-father-breaking-down-after-seeing-the-news-12197311.html

[18] https://www.livemint.com/opinion/online-views/does-the-collapse-of-byju-s-mean-the-end-of-edtech-11707136891702.html

[19] https://www.indiatoday.in/business/story/byjus-byju-raveendran-win-dispute-aakash-institue-stake-ranjan-pai-manipal-group-2498258-2024-02-06

[20] https://www.zomato.com/investor-relations/financials

public from the lens of corporate governance. A comparison across financial years 2019 to 2023 reveals some important changes in corporate governance and disclosure.

Table 1: Comparison of Governance Parameters of Zomato Prior and Post-Listing

Basis of Comparison	Prior Listing	Post Listing
Board size[21]	3	8
Board Composition	Managing director and nominee directors	Independent chairman, independent directors, executive director
No. of independent directors	Nil	5
Board meetings	12, 13, 21 (three years before listing)	14, 12 (2 years since listing)
Audit committee (AC)	Existed	Mandatory
Composition of AC	Managing director and nominee director	Independent directors
Meetings of AC	5, 7, 5 (three years before listing)	6, 4 (2 years since listing)
Other board committees	Corporate Social Responsibility Committee	Nomination and remuneration committee, stakeholders' relationship committee, risk management committee, IPO committee, investment committee, corporate social responsibility committee
Statutory auditors	Yes	Yes
Business responsibility report	No	Yes
Management discussion and analysis	Yes	Yes

[21] As per red herring prospectus, the size and composition are different. It was changed after the financial year.

Table 1 underscores the changes in the governance structure of Zomato. There is a stark change in board composition and leadership. The company has moved away from CEO duality. The same change is visible in the composition of AC. The number of board committees has increased drastically. One of the notable findings of this comparison is that Zomato started making changes in board composition and independence before issuing a red herring prospectus. It indicates the company started aligning its practices with listing requirements. In terms of requirements concerning statutory auditors, their reports, audit of financial statements, and internal controls there has been no change.

5. Conclusion

India has witnessed a surge in several start-ups and unicorns. The start-up ecosystem is gradually evolving in India and government initiatives are providing the required push to entrepreneurs. But the growth story has its challenges. One of the key challenges is regulatory architecture for start-ups. Growth should be real growth and not optics management. It is important to sensitize the players in the start-up ecosystem 'Fake It till You Make It' is not sustainable. Critics have rightly pointed out the gap between the value and valuation of start-ups. Valuation should be based on and reflective of sustainable growth, realistic expectations of profitability, ability to manage cash flows, and effective strategy for scalable and sustainable operations. The race to achieve unicorn status and go public is gaining momentum. Start-ups are reeling under pressure from all corners to be in the race. A competitive landscape is crucial but with checks and balances to curb undesirable practices. Imbierowicz and Rauch (2021) examined a sample of 98 unicorns and their analysis suggests that each unicorn is sued seven times a year. The majority of these lawsuits are for undesirable and fraudulent practices.

India has always strived to match international best practices of corporate governance for listed companies. The regulations and listing requirements have been updated accordingly. It is known for a fact that certain start-ups are larger than listed companies in terms of size and valuation. Governance and disclosure requirements are similar to those of listed companies must apply to them. Requirements such as independent directors, internal audit, audit committee and other regulations for listed companies are applicable for start-ups reaching certain valuations. India has reached a stage to frame specific regulations about transparency and disclosure, investor activism, effectiveness and independence of board, code of conduct, and founder's rights for start-ups. It is in the interest of all the stakeholders including founders. At this point, it is important to note regulatory requirements can be time-consuming and involve lengthy procedures. It might act as an impediment to fast-growing start-ups. It is necessary to strengthen the regulatory machinery for timely processing along with devising regulations.

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