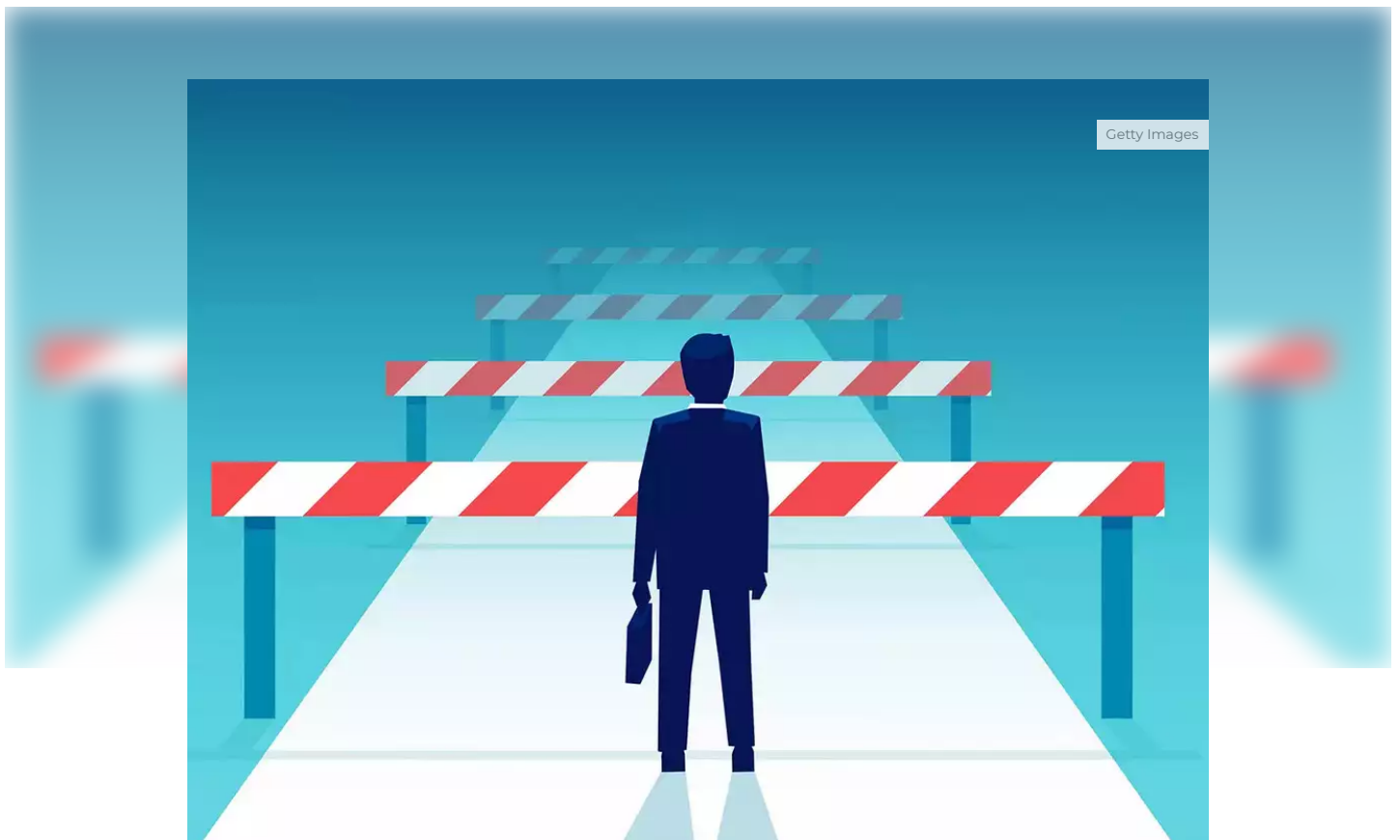


UNDER THE LENS

Financial misconduct and governance lapses: why it's a wake-up call for Indian startups

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Synopsis

Accurate reporting of financial statements is a pivotal responsibility of a startup and its founders. But the low tide of funding has exposed the dark underbelly of the startup ecosystem in India. Promoter greed and investor appetite for higher valuation are often leading to governance failures and bringing companies down.

Some adjectives go well with **startups** – dynamic, innovative, etc. But startups also face unique challenges. Financial mismanagement and unexpected market shifts can shake up a startup's stability and growth potential. With proactive measures and strategic decision-making, their founders and stakeholders can prevent this well ahead of time.

In recent times, several instances have come to light wherein a company inaccurately reported and filed financial statements with the authorities concerned. The low tide of funding has exposed the dark underbelly of the **startup ecosystem** in India — financial irregularities, glaring absence of **corporate governance**, and acts of omission and commission. Some companies typically report their financial figures inaccurately to deceive investors, leading them to

believe that their performance and profitability exceed actual levels.

Since 2022, India Inc has provided quite a few cases of corporate-governance lapses in startups such as BharatPe, Broker Network, Trell, and Zilingo, wherein the companies were accused of inaccurately reporting financials. Another illustration of financial fraud was seen in the beginning of 2023, when the founders of GoMechanic admitted to committing financial fraud by inaccurately reporting their financial statements.

The surprising, yet common, thread that was emanating across every instance was the fact that each of these companies was at an advanced stage of their growth journey and had every opportunity to have significantly better internal controls in place.

Who is driving the train?

The primary focus of the board of directors in most such startups is commonly driven by a concern for 'valuation'. Promoters and **investors** alike look for high trajectory growth and increasing valuations. This helps multiply the investment and provides a profitable exit. These instances of promoter greed and investor appetite for higher valuation have been a major cause for governance failures and brought down companies and their promoters globally as well.

With recent stories of corporate mis-governance spilling over to the mainstream, there is a genuine outcry that corporate governance needs to be strengthened in startups. It is a serious issue that needs to be addressed, not only by the founders alone, but also by everyone concerned. This will ensure that the reputation of the Indian startup ecosystem, built painstakingly, is not impacted.

The Mojocare case

One more instance of alleged financial fraud that has come to light recently is the health and wellness startup Mojocare. On June 17, 2023, Mojocare announced that it had laid off 80% of its staff (approximately 150 to 170) employees to improve its unit economics and enhance capital efficiency. Just a day after this announcement, on June 18, major investors of Mojocare confirmed, through a joint statement, that

- Mojocare's founders had admitted to overstating the company's sales numbers due to high pressure and revenue targets.
- The investors have not yet taken any legal action against the founders, as they have no evidence regarding siphoning of funds.
- In order to get more clarity on the financial irregularities, the investors have appointed Deloitte to conduct a forensic audit.
- The investors have found financial irregularities in the company and have identified that the business model of the company is not sustainable due to 'a variety of operational and market factors'.

- The company will scale down operations, and the investor group is working with the company through its transition.

Why financial statements matter

Accurate reporting of financial statements and penalties for non-adherence with the norms of the reporting standards are an integral part of Indian law. According to the Companies Act, 2013 ("CA 2013"), a financial statement includes the balance sheet, the profit and loss statement, the cash flow statement, a statement of changes in equity, if applicable, and any other explanatory note annexed to the documents referred above.

A company is required to ensure that all financial statements and notes annexed thereto give a true and fair view of the state of the affairs of the company. This means that no misleading impression of the company's fiscal state should be given. Further, these statements are required to be in compliance with the accounting standards prescribed by the central government, as recommended by the Institute of Chartered Accountants of India.

CA 2013 has imposed this additional level of liability on the directors to ensure that the directors do not deceive the stakeholders of the company by using the company's separate legal existence as a shield.

Remedies for maladies of financial mis-statement

They say that a journey of a thousand miles begins with a single step. For startups, the following four steps are the starting point of a journey to avoid financial irregularities.

#1: Strengthen financial management and corporate governance

Startups should implement robust accounting systems, governance framework, regular financial reporting and disclosures, and budgeting processes. Hiring experienced legal and finance professionals can provide expertise in governance, financial planning, cash-flow management, and risk assessment.

#2: Internal control enhancement

Establishing comprehensive internal controls helps mitigate the risk of financial irregularities. This involves implementing segregation of duties, enforcing policies and procedures, and conducting periodic internal audits to detect and prevent fraudulent activities.

#3: Diversification and long-term planning

Startups should focus on diversifying their revenue streams and reducing reliance on a single client or market segment. Long-term planning that accounts for potential economic downturns or market fluctuations can help mitigate financial risks and create a stable foundation for growth.

#4: Continuous monitoring and adaptation

Regular monitoring of financial indicators and key performance metrics is essential to identify early warning signs of financial irregularities or potential layoffs. Startups should adapt their strategies promptly by adjusting costs,

exploring new market opportunities, and fostering a culture of innovation and resilience.

A wake-up call

Accurate reporting of financial statements is a pivotal responsibility of the company and its directors. Non-compliance with the norms can lead to major setbacks, including the winding up of the company.

Founders must prioritise sound financial management practices, including accurate reporting, effective internal controls, and strategic planning. They should foster a culture of transparency, accountability, and ethical conduct within the organisation.

Investors, on the other hand, play a vital role in conducting due diligence before investing in startups. Thorough evaluation of financial statements, business models, and management practices can help identify potential red flags and minimise the risk of financial irregularities.

Active involvement in monitoring the company's financial health and providing guidance can also contribute to the prevention of irregularities. There is a need for the investors investing in startups to use their board nominees effectively and closely look at the company's corporate-governance principles, along with the overall business model, to understand if the company is likely to get into any trouble in the future. A savvy investor will spot a financial speed breaker a mile away.

Even as Mojocare is still being investigated, the fact is that the business and the reputation stand affected. There have been several instances of corporate-governance lapses in recent times. Whether or not this trend is reversible is something that only time will tell.

Financial irregularities pose significant challenges for startups. Strengthening financial-management practices, enhancing internal controls, and prioritising transparent communication during layoffs are vital steps to navigate these difficulties successfully. By adopting a long-term perspective and continuously monitoring their financial position, startups can position themselves for sustainable growth and success in an ever-changing business landscape.

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