Corporate Governance for Startups

For Prelims: Corporate Governance, SEBI, Confederation of Indian Industry (CII), Startups.

For Mains: Corporate Governance, Issues related to Business in India, Indian Startup Ecosystem, Challenges and Opportunities.

Source: ET

Why in News?

Recently, **Confederation of Indian Industry (CII)** has launched a corporate governance **charter for startups**, including a self-evaluative scorecard.

- This occurs during a period when companies like Byju's, BharatPe, and Zilingo have expressed worries about governance norms in the last 12-18 months.

What are the Key Provisions of the Charter?

- Charter will provide **suggestions on** Corporate Governance **tailored for** Startups and offer guidelines suitable for **different stages of a startup** which is aiming to **enhance governance practices.**
    - **Corporate Governance** in India is a set of rules, practices and processes by which a company is guided and controlled.
- **Self Evaluative Governance Scorecard:**
    - The charter includes an **online self-evaluative governance scorecard** that startups can use **to evaluate their current governance status** and its improvement over time.
        - It will allow startups to measure their governance progress, with score changes indicating improvements in governance practices as assessed against the scorecard from time to time.
- **4 key Stages of Guidance to Startups:**
    - **At the Inception stage:** The focus of Startup will be on:
        - Board formation,
        - Compliance monitoring,
        - Accounting, Finance, External audit, Policies for related-party transactions, and
        - Conflict resolution mechanisms.
    - **In the Progression stage**: A startup may additionally focus on:
        - Monitoring key business metrics,
        - Maintaining internal controls,
        - Defining a hierarchy of decision-making, and
        - Setting up an audit committee.
    - **For the Growth stage:** The focus will be on:
        - Building stakeholder awareness towards the vision, mission, code of conduct, culture, and ethics of an organisation,
        - Ensure diversity and inclusion on the board and

        - Fulfilling statutory requirements, according to the **Companies Act 2013** and other applicable laws and regulations.
    - **At the Going Public stage:** The Focus of the startup will be on:
        - Expanding its governance in terms of monitoring the functioning of various committees,
        - Focus on fraud prevention and detection,
        - Minimise information asymmetry,
        - Evaluating board performance.
- **Valuation:** The valuations of businesses should be kept as realistic as possible.
    - Startups may strive for long-term value creation rather than short-term valuations.
- **Long-Term Goals**: The needs of the **business entity should be separated from the personal needs of its founder(s),** but at the same time, the goals and needs of the founders, promoters, and initial investors should be aligned with the long-term goals of the business.
- **Separate Legal Entity**: The **startup** should be maintained as a separate legal entity with the organisation's assets distinct from the founders' assets.

What is a Startup?

- **About:**
    - According to **(Department for Promotion of Industry and Internal Trade) DPIIT,** to be considered eligible for recognition, a Startup must meet these criteria:
        - Have been in operation for no more than 10 years since its incorporation.
        - Be registered as a **Private Limited Company, a Registered Partnership Firm, or a Limited Liability Partnership.**
        - Have an annual turnover not exceeding **Rs. 100 crore** for any financial year since its incorporation.
        - Not have been formed by **splitting up or reconstructing** an already existing business.
- **Scenario of Startup in India:**
    - India has the **3rd largest startup ecosystem** in the world and is expected to witness **Year-on-Year growth** of consistent annual growth of **12-15%**
    - India ranks **2nd in innovation quality** with top positions in the quality of scientific publications and the quality of its universities among middle-income economies.
    - As of May 2023, India is home to 108 **Unicorns** with a total valuation of USD 340.80 bn.

What is Corporate Governance?

- **About:**
    - Corporate governance, which refers to the **system of rules, practices, and processes** by which a company is directed and controlled, plays a crucial role in ensuring that businesses are run ethically and in the best interests of their stakeholders.
    - It enforces **strong ethical standards** and **holds individuals accountable** for their actions.
- **Principles of Corporate Governance:**
    - **Fairness:** The board of directors should treat shareholders, employees, vendors, and communities with fairness and equal consideration.
    - **Accountability:** The board is required to explain the purpose of the company's activities and report on its conduct.
    - **Transparency:** The board should ensure that **timely, accurate, and clear information** is provided about financial performance, conflicts of interest, and risks to shareholders and other stakeholders.
    - **Risk Management:** The board and management are responsible for identifying and controlling various risks.
        - They should take action based on recommendations to manage these risks and inform relevant parties about their existence and status.
    - **Corporate Social Responsibility (CSR)**: It involves integrating **environmental, social,**

and governance (ESG) considerations into business strategy and operations, and contributing positively to society and the environment.

- **Regulatory Framework in India:**
  - **The Companies Act, 2013**
  - **Securities and Exchange Board of India (SEBI)**
  - **Institute of Chartered Accountants of India (ICAI)**
  - **Institute of Company Secretaries of India (ICSI):** It issues secretarial standards as per the provision of the Companies Act, 2013.
- **Committees Related to Corporate Governance:**
  - **Confederation of Indian Industry (CII) National Task Force on Corporate Governance (1996):**
    - The task force, chaired by Rahul Bajaj, **developed a voluntary code of conduct for Indian companies.**
  - **Kumar Mangalam Birla Committee (1999):**
    - This committee was set up by the **SEBI** to develop a **mandatory code of** corporate governance for listed companies.
    - The committee's recommendations addressed issues such as board composition, independent directors, audit committees, and risk management.
  - **Naresh Chandra Committee (2002):**
    - This committee, constituted by the **Department of Company Affairs (DCA),** examined various corporate governance issues related to statutory audits, the independence of auditors, and the role of independent directors.
    - Its recommendations led to significant changes in the **Companies Act.**
  - **Narayana Murthy Committee (2003):** This SEBI-constituted committee reviewed the implementation of the corporate governance code by listed companies.
    - The committee's recommendations helped strengthen the code and improve its effectiveness.
- **Importance of Corporate Governance:**
  - **Strengthens Investors Confidence:** Strong corporate governance maintains investors' confidence in the financial market, as a result of which companies can raise capital efficiently and effectively.
  - **International Flows of Capital**: It enables companies to reap the benefits of the global capital markets which will contribute to economic growth.
  - **Increased Productivity:** It also minimises wastages, corruption, risks and mismanagement.
  - **Brand Image:** It helps in brand formation and development of a company. It ultimately increases capital flows from **foreign institutional investors (FII)** and **foreign direct investment (FDI).**
- **Challenges:**
  - **Ensuring Objective Board:** It is a widespread practice in India for the associates and **relatives of company owners to be selected as board members.**
  - **Performance Evaluation of Directors**: Corporate firms sometimes do not share the results of performance evaluations to avoid public scrutiny and negative feedback.
  - **Removal of Independent Directors:** Sometimes, Independent directors are easily removed from their positions by the promoters if they do not side with promoters' decisions.
  - **Founders Control and Succession Planning:** In India, founders' ability to control the affairs of the company has the potential of derailing the entire corporate governance system.
    - Unlike developed economies, in India, the identity of the founder and the company is often merged.

How to Improve Corporate Governance in India?

- **Strengthen Regulatory Framework:** Continuously update and enforce corporate governance regulations to align with international best practices.
- **Independent Directors and Diversity in Board Composition:** It ensures their autonomy and effectiveness and brings a broader range of perspectives and expertise to decision-making processes.

- **Transparency and Disclosure:** Mandate comprehensive and timely disclosure of financial information, ownership structures, related-party transactions, and corporate governance practices.
- **Shareholder Rights and Activism:** Enhance shareholder rights, including voting rights, information access, and participation in key decisions.
  - Foster constructive dialogue and engagement with all stakeholders.
- **Continuous Evaluation and Improvement:** Establishing mechanisms for ongoing evaluation and benchmarking of corporate governance practices.
  - Regularly solicit feedback from stakeholders and adapt policies and procedures accordingly.

Drishti Mains Question:

What is Corporate Governance? What is the need of a regulatory framework for corporate governance in India? Suggest measures to improve Corporate Governance in India.

UPSC Civil Services Examination Previous Year Question (PYQ)

Prelims:

Q. What does venture capital mean? (2014)

(a) A short-term capital provided to industries
(b) A long-term start-up capital provided to new entrepreneurs
(c) Funds provided to industries at times of incurring losses
(d) Funds provided for replacement and renovation of industries

Ans: (b)

Mains:

Q1. In the light of the Satyam Scandal (2009), discuss the changes brought in corporate governance to ensure transparency and accountability. **(2015)**

Q2. What do you understand by the terms ‘governance’, ‘good governance’ and ‘ethical governance’? **(2016)**