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Startup Governance: Promoting Effective Governance Amongst Social Enterprises

Position Paper # 2

During a startup's inception, there is very little emphasis on governance. Entrepreneurs dedicate their resource and time to launching their operations. Governance gains relevance once a startup opens up to external investment. Establishing a sound governance framework is crucial, especially for impact-driven enterprises that must closely align their business interests with those of the wider community. It creates tangible business values through responsible planning, increased accountability and greater transparency, which encourages resource stewardship and instils confidence among stakeholders. Yet research indicates that startups in emerging markets are reliant on traditional governance approaches, which tend to be informal, unstructured and rigid. This position paper highlights the need for startups to move away from conventional governance practices, to more transparent, equitable and evolving governance models that are conducive to present day impact-focused entrepreneurship.

INTRODUCTION

'Governance' refers to how an organisation is run, directed and controlled. Good governance manifests when an organisation designs and puts in place actors, structures, policies and procedures, which ensure that it functions effectively (Cox et al, 2014). The impact investment and associated entrepreneurial ecosystem present unique governance-related opportunities and challenges for startups. A well-rounded governance structure implemented early on will allow enterprises with sustainability solutions for low-income markets to innovate within a balanced framework of authority, decision-making and accountability. This can increase profits while also generating higher sustainable impact. However, enterprises operating within conventional governance paradigms often face challenges relating to protection of stakeholder interests, ambiguous personal and enterprise distinctions, and difficulty in attracting and retaining talented professionals.

GENERAL CONSENSUS

Startups operating in emerging markets often employ governance models that are informal, ad hoc and unstructured (Yap, 2009). This practice goes beyond the social entrepreneurship space, and is frequently observed in mainstream markets as well. However, for impact-oriented enterprises such haphazard governance approaches create a number of challenges, which threaten long-term business success and sustainability. Perhaps the most pervasive challenge relates to the protection of shareholder interests. In a study on investor protection and governance, Porta et al (2000) observed that prospective shareholders and creditors are wary of businesses with governance limitations that result in highly concentrated ownership, poor transparency, and absence of accountability. Impact investors are less likely to invest in startups with weak governance systems that offer little security or recourse from corruption, expropriation and other violations of minority shareholder rights.

Another key governance challenge faced during the early-stages is that the enterprise and personal-boundaries are not adequately distinguished (OECD, 2009). This holds particularly true in the case of finance and accounts. It becomes increasingly difficult to ascertain how company-owned assets are used by the founders and vice versa, when the assets are not legally separated. As a result, the control environment tends to be customised to their needs, which leads to an over-reliance on a few key people rather than on well thought out structures and processes. Such situations arise because of the difficulties faced by startups in attracting and retaining qualified specialists and professionals in key management positions.

Challenges also compound when governance systems fail to evolve in sync with the growth of the enterprise. Inefficiencies begin to manifest when startups begin to scale and their operations grow in size and complexity. For example, in the absence of formalised governance practices and systems, founders may tend to lose sight of their missions and goals as the business grows in size. This leads to inefficiencies such

as oversight, lack of accountability to stakeholders, and internal conflicts that threaten the continuity of the business (Abouzaid, 2011). A failure to take pre-emptive steps and measures to address these challenges can compromise a startup's survival.

OUR POSITION

Through experience, Ennovent has found that it is important to consider both strategic and operational reasons for adopting good governance practices during the early phases of an enterprise. Firstly, investors seek and reward enterprises with good governance structures. Dye et. al, (2007) found that investors in emerging markets are willing to pay 30% more for shares in companies with good governance. Entrepreneurs must create organisational structures, systems and processes that ensure the overall direction, supervision and accountability of the business (Cornforth, 2003). These governance mechanisms can include professional boards, monitoring systems and signalling mechanisms. Without these, there is less likelihood that startups will raise funds from investors.

Secondly, a board that is carefully selected and well managed, with pre-determined responsibilities and codes of conduct, will help the startup reach its goals. Such Boards can monitor the performance of management against benchmarks that reflect the goals and missions of the enterprise. Boards can ensure that management complies with its own governing document as well as external legal and compliance requirements, such as audits as well as accountability measures to increase transparency towards external stakeholders. While the goal of accountability is to control and monitor an organisation's performance, it plays a key role in organisational learning by evaluating and embracing errors as opportunities to improve. This helps enhance responsiveness to environmental uncertainties, improve communication structures, provide incentives and training, build simple and concrete information systems, and strengthen relationships between the mission and accountability (Ebrahim, 2005).

Boards help founders and management teams reach their goals and missions in several ways. Board members can compensate for the lack of in-house competencies and expertise by providing strategic support and guidance, which helps to develop and implement effective business models. A well-regarded Board can also provide access to valuable networks that can help raise awareness about the startup, solve business development challenges, and aid fundraising by signalling credibility to investors. Boards also help in scrutinising major capital expenditures, overseeing risk management, advising on investment strategies, remuneration policies and reviewing the adequacy of internal control systems (Noble et al, 2012).

Thirdly, all organisations today need to look at governance through a balanced triple bottom line lens, given the rising relevance of market-driven sustainability. There is a clear need to balance social and environmental impact with fiscal responsibility, while coordinating a myriad number of stakeholder interests including those of investors, employees, regulators, clients and beneficiaries. Compared to financial and accounting metrics, the indicators and tools for measuring social and environmental performance are still relatively young. A strong triple bottom line monitoring protocol that sets these objectives and determines the means to attain them effectively facilitates better management. It creates immense business value by improving reporting systems, compliance with legal policies, as well as ensuring overall transparency and accountability while securing long-term sustainability (Abouzaid, 2011).

Lastly, governance systems should evolve in unison with the lifecycle of the enterprise. For example, startups should be supported to implement sound governance practices such as convening boards at an early stage, developing clear signalling mechanisms, and implementing succession plans. It is important to address governance concerns at an early-stage, as external funding is now required even at the seed stage to develop prototypes, launch innovations, and run pilots. It is also important to evaluate and tailor governance structures regularly as the enterprise evolves and its legal or financial structure, management and external environment changes.

PRACTICAL INSIGHTS

Ennovent manages the Impact Investment Holding ('IIH'), which actively supports early-stage enterprises to make a sustainable impact in low-income markets by providing financial capital and non-financial startup support. Based on our investment experience, below are some practical insights on the advantages of clearly structured interactions, roles and responsibilities of the board, investors and the management, that are critical to impact-focused enterprises after they receive funding. While in theory investors provide capital, board members represent the investors and the management executes the business, there are several challenges in practice:

- Management are focused on customers and competition with disregard to governance practices.
- Management teams are often averse to building boards because of the high levels of controls they impose.
- The functions, interactions and coordination between the board, investors and management are often not clearly specified.
- Investors directly interfere in operational management decisions that eventually create confusions about strategies and result in execution inefficiencies.

- Early-stage enterprises typically set up boards out of their network of family and friends. While this may reduce the initial effort, it can be a disadvantage at a later stage if board members do not possess the relevant skills, network and reputation.

CONCLUSION

It is evident that sound governance structures will add value by attracting external investors, retaining professional talent, providing means to institutionalise the business model, implementing defined strategic plans and improving the brand image of startups. Impact-focused enterprises must consider this when competing for resources alongside global companies, particularly in low-income markets with institutions, regulatory frameworks and enforcement mechanisms that do not inspire the confidence of investors. However, while good governance is ideal, it is difficult to achieve in totality (Yap, 2009). Enterprises must embrace it as an on-going process that needs to be tailored to evolving business requirements.

ABOUT ENNOVENT

Ennovent is a venture catalyst that takes innovative businesses to unexplored low-income markets in developing countries. We offer customised venture projects to entrepreneurs, corporates, funders and NGOs that provide access to startup expertise, local capacity, diverse funding and global networks. Through fair partnerships, we share the risks and rewards of optimising sustainable impact and profits in low-income markets. Since 2008, Ennovent has catalysed over 240 ventures in 35 countries through 70 projects.

KEY SOURCES

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