British International Investment

FMO VENTURES

Governance red-flags in Venture Capital start-ups

Interpreting and acting on warning signs

Guidance

Published: 11/2023

Report leads:
British International Investment
FMO Ventures

Disclaimer

This Guidance Note is supported by British International Investment plc (BII) and FMO, the Dutch Development Bank.

This note is provided for general information and guidance purposes only. BII and FMO accept no responsibility for any reliance placed on the information contained in it. Any reliance you place on such information is strictly at your own risk. In no event will BII and FMO be liable for any loss or damage whatsoever including without limitation, indirect or consequential loss or damage, arising out of, or in connection with, the use of or reliance on this document.

BII is the UK's Development Finance institution. More information can be found on https://www.bii.co.uk/en/.

For FMO, this Guidance Note has been supported by the FMO Ventures Program Technical Assistance Facility, co-funded by the Dutch Government and European Union. The contents of this Note do not necessarily reflect the views of the European Union. More information about the FMO Ventures Program can be found at the FMO website: www.fmo.nl/venturesprogram.

Ministry of Foreign Affairs of the Netherlands

Acknowledgements

This Guidance note was commissioned by BII and FMO, and prepared by Agile Governance Platform. Lead contributors were Agile Governance Platform and Giulia Rigazio from BII, and oversight provided by Huma Yusuf, also from BII. Additional feedback was provided by Shirley Payet-Jacob from BII and Jasper Veel, Zunaira Javed and Tessa Blokland from FMO. We also thank Abhishek Raj from Chiratae Ventures for his inputs.

Foreword

This Guidance Note is the first in a series of three which aims to bring practical, actionable advice about good practice to follow for Venture Capital fund managers in emerging markets and also for their portfolio companies, as well as any other investor in startups, in the area of governance of startup companies.

BII and FMO have been among the 35 leading development finance institutions which promote the Corporate Governance Development Framework. This framework grades corporate governance practices from basic to best practice across different attributes using a *Progression Matrix*. The IFC has extended the general progression framework to develop methodology and tools for corporate governance; and has applied the progression matrix specifically to corporates as well as to family or founder owned unlisted companies and to small and medium enterprises.

In a similar vein, others have more recently developed applied governance for startup companies. Among a growing list, we would like to acknowledge in particular, the 2019 *Corporate Governance for Early-Stage Innovative Companies,* Resource Guide prepared by the Center for Financial Inclusion and FMO; and the 2023 *Startup governance playbook* published by Deloitte India and the Indian Venture Capital Association.

This Guidance Series seeks to build on and especially apply the insights from these frameworks to the context of fund managers and investors who shape and participate in the governance of their portfolio companies.

The Notes are built around hypothetical case studies in which readers are invited to apply the frameworks to situations which are based on real life. However, these cases studies are fictitious and are not based on actual BII or FMO investments. The Notes do contain stories based on published information from recent relevant cases.

Contents of this Guidance Note

Glossary	
AFS	Annual financial statements.
Business Integrity (BI)	'An approach looking at how businesses are exposed to financial crimes or unethical practices, including via third-party relationships, but also how the corporate governance, risk and management systems, organisational ethics, and values of a company can have impact on performance. Key business integrity topics may include corruption and fraud, money laundering and terrorism financing, sanctions breaches, tax evasion, conflict of interest, whistleblowing, data protection, political exposure, etc.' (Source: BII)
Early-stage company	Startup companies in the early stages of their operations, typically up to a Series A funding round still dependent on external capital raising.
Governance	The combination of structures, policies, and controls by which organisations make decisions, align relationships to add value and oversee risk and compliance in order to achieve their purpose.
NED	Non-executive directors not involved in day-to-day decision-making may be independent or else appointed by shareholders or linked to founder/ managers.
Warning signs	Signals of heightened risk which require noting and follow up.

Full list of warning signs

List of potential action steps

Why does good governance matter for startups?

For startup companies, **good governance**:

Enhances business performance through better decision-making and alignment.

Makes companies more attractive to investors and/or acquirers.

Helps to manage risks which can otherwise undermine financial and commercial performance and even result in failure.

Evidence of the link between governance and financial performance

IFC tested the hypothesis that better corporate governance is associated with better performance using client surveys and portfolio financial, economic, and development outcome data.

Using data from a sample of 330 portfolio companies from around the emerging and developing world, the study reported a positive association of better governance scores with a credit risk rating which was 1.5 points higher on average over a four-to-five-year period; that is, that better governance at the start reduced the credit risk on the investment.

The study also found that when corporate governance improved during the investment period, it led to around 20% higher performance measured by indicators including return on equity and return on invested capital, and economic return on equity and economic return on invested capital.

The IFC study was not specific to venture capital-funded companies. However, there is increasing evidence from a rash of recent startup failures of the link between poor governance and poor financial performance, which can even lead to corporate failure. This happens in both advanced and emerging capital markets. As one example, this Note includes the example of cryptocurrency exchange FTX which raised over $2 billion in VC funding but failed spectacularly in 2022, with investors and customers losing their money; and the founder convicted of fraud and conspiracy.

Why does good governance matter for startups?

The **startup journey** involves an ongoing juggling of priorities related to raising funds, achieving product market fit, hiring a team, and scaling the business in a context of scarce time and resources.

Founders often accept the importance of good governance in principle, partly because investors require it in some form. However, in practice, many founders, especially first-time founders, do not pay the issue adequate attention until a crisis erupts. By then, it may be too late to prevent loss: startups can grow rapidly but often, their systems and controls do not keep up.

Especially when they have a board seat, but even when they do not, **investors have both the ability and the responsibility to shape an investee's governance approach** in a way which is:

- **Phased:** Evolving as the company grows over time.
- **Proportionate:** Varying in intensity and nature based on the stage and size of the company and the risks to which it is exposed.
- **Adaptive:** Changes based on learnings and feedback about risks and priorities.

Governance requires reading signals and acting on them

Governance is primarily the responsibility of the board of directors and leadership of a company, but investors also shape the governance of their investees.

This happens through how they engage with founders/ CEOs from due diligence onwards and through exercising their rights as shareholders, especially when appointing a nominee to the board.

A **governance framework** is the combination of structures, systems, policies, and processes which guide, direct, and oversee how organisations achieve their purpose.

In many countries, financial regulators and industry associations have set out corporate governance codes, which usually apply mainly to large public companies. International investors have also developed governance frameworks and adapted them for SMEs.*

*This view is based on the Corporate Governance Development Framework endorsed by 35 leading development finance institutions and investors. The CGDF general approach has five themes, four of which map to these four closely with slightly different names (control environment instead of risk and compliance; and disclosure and transparency instead of finance and reporting) and with an additional one on the rights of minority shareholders. The CGDF framework tailored specifically for SMEs has six themes – these are versions of the earlier five with an additional one for the governance of stakeholder engagement in the context of the evolution of SMEs, which are often family-owned. We use these four themes as a simplified version most relevant for startups specifically.

Governance requires reading signals and acting on them

For startup companies, a sound governance framework addresses at least the **four components** shown below.

Sound decision-making	Healthy practices in the way in which decisions are made include but is not limited to the structure, composition and practices of the board of directors and senior management.
Aligned people and culture	The quality of relationships among key players like investors, founders, board members, and staff and their commitment to good governance, as well as to good practices in environmental, social, and business integrity areas. These are all embedded in 'the way things are done here,' i.e. the organisational culture and in management incentives.
Consistent finance and reporting	The adoption of appropriate accounting policies and practices which ensure transparent and timely disclosure of relevant metrics and financial results to the board and investors while also keeping close track of cash flow and cash burn projections.
Managed risk and compliance	The way in which risks of all types are identified, assessed, and managed in the organisation and the controls to manage those risks inside the organisation.

What is this Guidance Note about?

Even early-stage companies are rather like icebergs: a lot more is going on than an investor or even a board member can see. The information 'water-line' changes according to the role investors play.

An investor **not on the board** may see this much

Read more on page 10

An investor with a **seat on the board** may see this much more

Read more on page 11

And the investor which has **specialists who engage**, may see more still

Read more on page 12

But investors will never have a full line of sight over the inner workings which founders and staff members have and have limited time and resources to apply to a single investee.

Investors have to learn to read the signals they do see well.

They have to make wise decisions about actions to take.

This Guidance Note will help you to:

1. Read the signals better
2. Decide on actions to take

What is this Guidance Note about?

Even early-stage companies are rather like icebergs: a lot mo
see. The information 'water-line' changes according to the r

An investor **not on the board** may see this much
Read more on page 10

An investor with a **seat on the board** may see this much more
Read more on page 11

And the investor which has **specialists who engage**, may see more still
Read more on page 12

But investors will never have a full line of sight over the inner workings which founders and staff members have and have limited time and resources to apply to a single investee.

This **Guidance note** is about reading and acting on warning signs of risk across all stages of startup growth.

The **absence of an agreed or appropriate governance framework is a warning sign** in itself, as are **delays or failure to implement an agreed framework**.

The second note in this series will describe the elements of an appropriate governance framework for startups to manage risks and related red flags proactively.

wise
ions

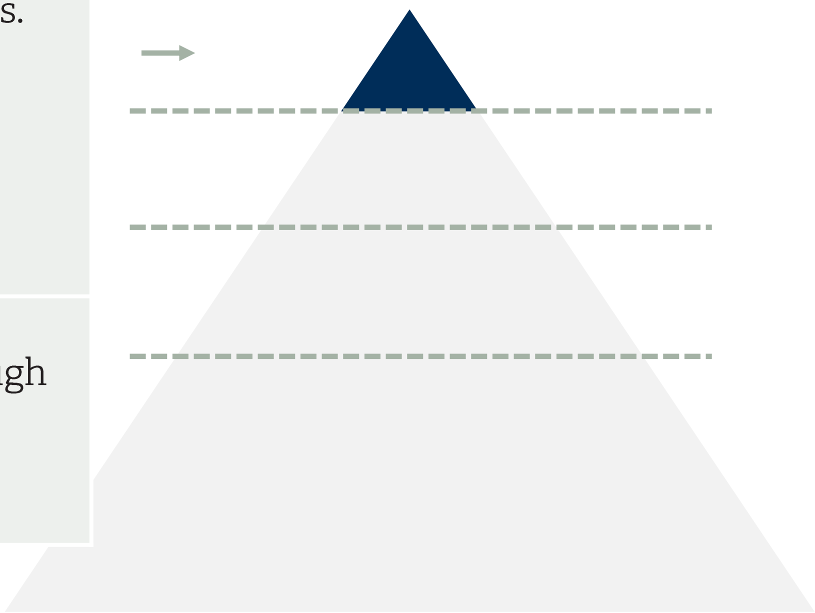
1 Read the signals better

2 Decide on actions to take

An investor not on the board

Investors collect **information from a range of sources** inside and outside a portfolio company such as these:

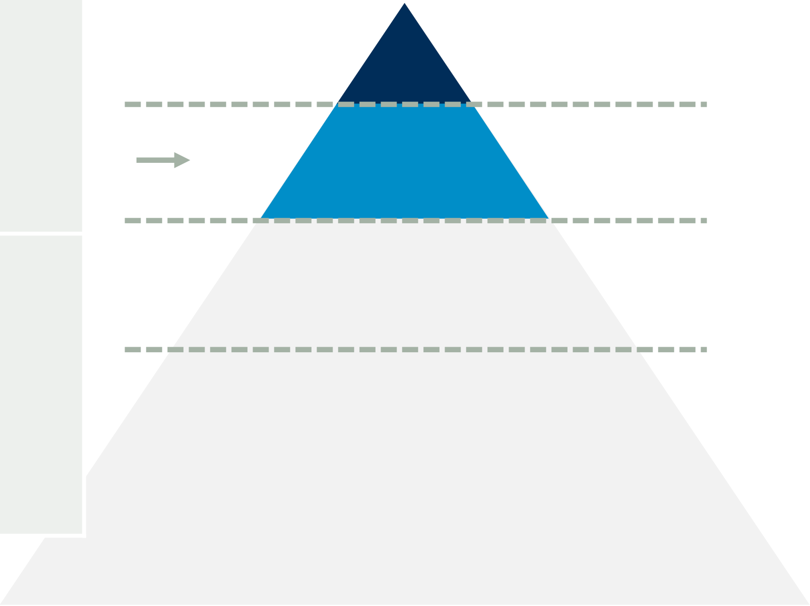
	From the company	From outside sources
Structured	• Due diligence information at investment. • MIS and financial reports and any other information sharing agreed under the shareholders' agreement • Annual financial statements. • Reports from standard or special audits or investigations.	• News media reports. • Social media.
Unstructured	• Meeting with management or board members. • Engagement with staff during site visits. • Whistleblower reports.	• Market news through contacts or events. • Reference checks.



Investor with a seat on the board

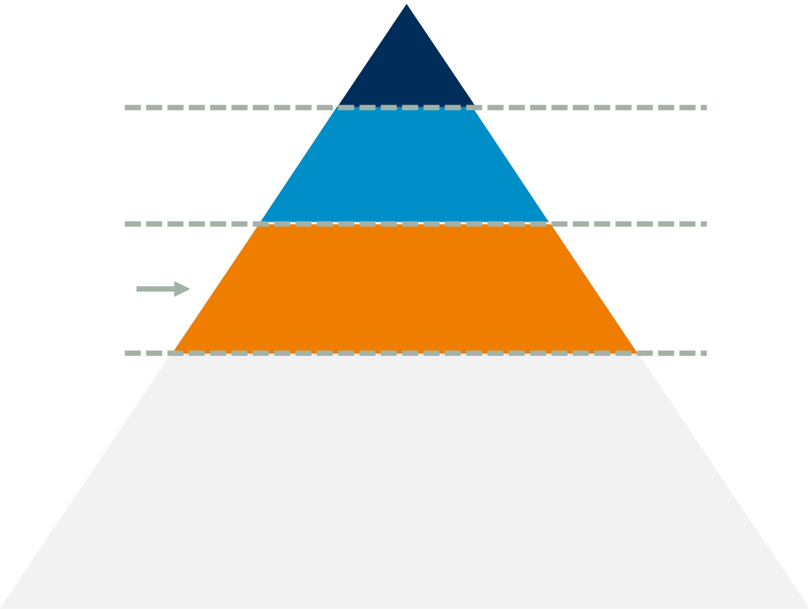
In addition, investors can leverage a board representation to collect further information from sources like these.

	Boards
Structured	• Board packs. • Board presentations. • Special reports to the board.
Unstructured	• Board interactions. • Meetings with other directors outside of the board. • Meeting managers in and around board meetings.



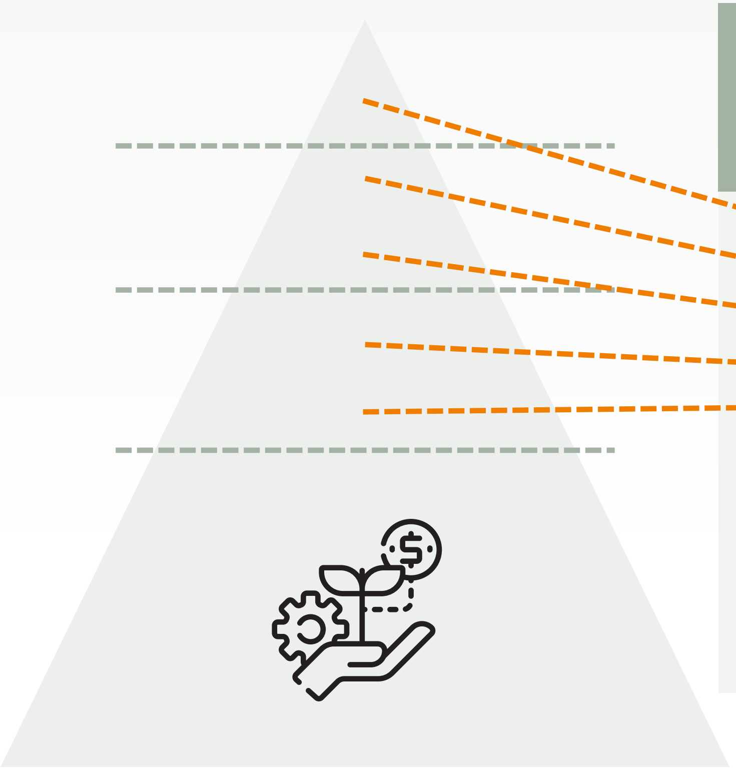
Investors with specialist staff

Investors with **specialist staff** who engage a portfolio company in particular areas such as Finance, ESG or Risk, will have **additional deeper sources of information** about these specific topics, including access to staff members who are not executives, but will need to combine this deep information with other sources to read signals.



Reading the signals

A startup company sends out a **stream of signals about its condition and performance**. It takes time and effort to monitor all these signals. Investors cannot afford to waste time by taking action based on false signals. To avoid wasting time and resources, investors can learn to filter the signals to look for true warning signs of increased risk, which may require action.



Filter 1	How likely is this signal to be a true warning?

Many signals are simply 'noise'. i.e., without any significant risk attached. To weigh this means considering the source as well as the pattern over time in this company.

Filter 2	If the true warning materialised, how severe would it impact the company?

Even if a warning sign is likely to be true, investors still need to assess the severity of the risk before deciding on the appropriate course of action.

The '**SMACS**' list categorises common warning signs to look for. →

A list of possible ‘SMACS’

Full list of warning signs

‘This SMACS of greater risk.’ Some signals from companies are more likely to carry warning signs. The table below uses the acronym to categorise common warning signs, showing some of the most common examples of each.

S	Suspicious information or behaviour	» Repeated errors or re-statements of material figures. » Actuals consistently too close to or well above forecasts. » Unexplained changes in the lifestyle of senior managers.
M	Missing pieces	» Key indicators are not tracked or reported. » Lack of key financial controls or oversight. » No policies in important areas. » Bypassing of established board processes.
A	Acute delays	» Late investor reports or board packs. » Delayed audits. » Slow decision-making in key areas. » Delayed payments to funders or suppliers.
C	Conflicts or complaints	» Tensions or disagreements among founders or board members. » Hiring or contracting of unqualified family and friends. » Bad press and social media.
S	Shifting people and strategies	» Employee churn or unannounced retrenchment. » Lack of role clarity and responsibilities among managers. » Constantly changing plans.

S Suspicious information or behaviour

Signals	What could this signal mean?
1.1 Obvious errors in reporting materials. 1.2 Repeated restatements of material figures. 1.3 Inconsistencies in financial reporting (e.g. applying unusual or distorting accounting principles).	» Inexperienced staff or lack of capacity. » Unclear strategy or desire to look good to investors. » Desire or attempt to conceal internal fraud and/or inflate revenue or valuation. » Lack of judgement or management out of its depth.
1.4 Actuals in reporting materials, which are either too close to forecast or too far above without adequate explanation.	» Good forecasting. » Business is taking off. » Managing expectations may cover up flaws. » Desire to impress by changing results.
1.5 Founders or senior managers display visible changes in lifestyle without explanation (e.g. there is mention of new cars, houses, club memberships disproportionate to their earnings).	» They have other sources of income or wealth. » Extracting money illegally from business. » Receipt of illicit payments from others.

S Suspicious information or behaviour

Signals	What could this signal mean?
1.6 CEOs or senior managers are evasive in response to the board or investor questions (e.g. they do not give direct or clear answers).	» They may not know the answers because they are out of their depth and do not have adequate support, but do not feel safe to show ignorance. » They are concealing the truth about failure or malpractice by creating confusing or incomplete information.
1.7 Founders who manage different divisions do not engage and disclose information adequately to the staff on their teams.	» Founders are covering up unethical practices. » Founders do not have the right people in place.
1.8 The size or sector of business of a major supplier does not match the expected profile of the company's needed inputs (e.g. a software development company reports major purchases from a small agricultural input supplier).	» Supplier profile is outdated or inaccurate. » Fraud may be happening through over-invoicing.

M

Missing pieces

Signals	What could this signal mean?
2.1 Key indicators of performance are not tracked or reported consistently. (e.g. a Profit and Loss statement is provided but no balance sheet and no cross-check to the accounting system).	» Lack of priority given to performance. » Lack of accountability by management. » Fraud is being concealed.
2.2 Key financial controls are missing, such as: (i) Segregation of duties (e.g. same person giving sole responsibilities for major/conflicting tasks) or (ii) Lack of financial oversight (e.g. financial controller operating in a silo without management oversight) or (iii) Key records or recons kept in separate offline systems without integrity controls.	» Lack of concern for risk by management. » Risk of internal fraud. » Lack of capacity to implement.
2.3 Appropriate policies in important areas are missing and/ or not applied, e.g. code of ethics, conflict of interest policy or bad debt provisioning policy.	» Lack of understanding of the importance of these policies. » Disagreement over the priority of particular policies. » Desire to avoid accountability through lack of clarity. » Inflating profit through the absence of sound accounting.
2.4 Policies and procedures are not followed consistently, e.g. approval procedures for material spending are overwritten or bypassed, or material decisions are not approved at the right level.	» Lack of understanding among staff. » Poor culture of accountability. » Overriding of controls.

M Missing pieces

Signals	What could this signal mean?
2.5 Material contracts, e.g. with suppliers, are not discussed by the board, which is only informed after signing.	» Lack of transparency, which may mask conflicts of interest or fraud. » Inadequate policy framework defining materiality and specifying actions.
2.6 Auditors perform an online-only audit without visiting or directly extracting data from the financial system.	» A risk that the audit is not based on true underlying information. » Auditors may be colluding with founders to misrepresent the company's situation.
2.7 Board reporting does not regularly include a list of outstanding litigation or regulatory violations.	» Management is concealing the true extent of litigation risk or ongoing issues at the company. » Understating of contingent liabilities to inflate valuations.
2.8 Material decisions are taken outside of board meetings.	» The company lacks sufficient skills and expertise on its board, so it has to rely on advisors and others. » The board is being bypassed so that it does not exercise its authority and oversight.

A Acute delays

Signals	What could this signal mean?
Prolonged and unexplained delays in: 3.1 Distribution of management accounts, quarterly financial reports or investor updates. 3.2 Finalisation of annual audited financials. 3.3 Receipt of board packs before meetings. 3.4 Holding board meetings. 3.5 Responding to investor/ shareholder requests. 3.5 Statutory or external audits.	» Inexperienced staff. » Lack of capacity in finance or operational departments. » First-time audit. » Lack of policies or clarity. » Attempts to cover up malpractice or fraud.
3.6 Making scheduled payments to investors (interest, tranche repayments, etc).	» Cash flow difficulties. » Inability to manage cash flow well. » Financial distress caused by underlying fraud or financial mismanagement.

C Conflicts or complaints

Signals	What could this signal mean?
4.1 Regular disagreements between co-founders, which may surface at the board and/or from feedback from the senior team.	» Resources are distracted from key business priorities. » Unclear strategy. » Poor decision-making. » Lack of conflict management protocols.
4.2 Co-founders are not coachable; e.g. they take personally and respond defensively to constructive advice from others.	» Mistakes may be covered up. » Poor decision-making. » Culture of learning and growing is not promoted.
4.3 Poor working relationship between Chair and CEO (or other senior managers) shown by misaligned views, lack of transparency, and frustration in board meetings.	» Unproductive board meetings. » Lack of effective oversight. » Risk of sudden departure for business continuity.
4.4 Avoidance of conflict even where expected or needed; and decisions not clear and timebound, repeated/circular discussions on key topics.	» Delays in important decisions. » Failure to confront needed issues means that they may metastasise until a crisis erupts.
4.5 Contracts with a supplier or hiring of staff members related by family or business ties to a board or staff member.	» Related party may offer the best deal, and the relationship may have been disclosed. » Conflict of interest, i.e. related party may be receiving preferential terms which prejudice the company.

C Conflicts or complaints

Signals	What could this signal mean?
4.6 Upwards trend in complaints from customers, suppliers or staff and/or whistleblower complaints.	» Unhappiness due to other issues, e.g. staff retrenchments. » Failure to focus on customer's needs. » Violations of company policy or ethics. » Company is violating laws. » Competitors undertaking vexatious litigation.
4.7 Increasing and serious legal actions initiated against the company or its promoters.	» Violations of company policy or ethics. » Misalignment of investors' values. » Company is violating laws. » Competitors undertaking vexatious litigation.
4.8 Undisclosed regulatory or law enforcement actions against the company, or lack of proactive disclosure of business integrity or ESG incidents.	» Lack of transparency. » Coverup of deeper problems.
4.9 Investors co-invest in a personal capacity.	» Potential for conflicts of interest if not fully disclosed and managed.
4.10 Investors invest in competitors at the same time.	» Conflicts of interest. » Restricted flow of information.

S Shifting people and strategies

Signals	What could this signal mean?
5.1 Repeated ad hoc funding requests for bridging finance to shareholders.	» Inadequate financial planning and cash management. » Risk of a coming cash crunch. » Financial distress is caused by underlying fraud or financial mismanagement.
5.2 Business plans, budgets, strategy, product, go-to-market approach, M&A decisions, or other operational issues keep changing (many 'pivots') without appropriate disclosure or oversight.	» Poor or slow decision-making. » Poor product market fit, slow customer uptake or other poor business metrics – leading to cash constraints, and difficulty raising capital, etc. » Conflict between senior team and/or founders. » Influenced by new investors, which may want new strategy – and have undue influence.
5.3 High levels of churn among senior managers, especially the finance and legal team.	» Poor hiring decisions and processes. » Uncompetitive packages. » Toxic culture. » Favouritism by founders and only hiring 'yes people'. » Pressure is placed on professionals to conform to unethical standards.
5.4 Delays in the hiring of key roles or shifting hiring priorities with hiring not on the basis of experience and fit.	» Inexperienced management. » Uncompetitive packages. » Shielding areas of the business from appropriate competence or oversight. » Favouritism or collusion.

S Shifting people and strategies

Signals	What could this signal mean?
5.5 Co-founders lead different departments with full autonomy, with risk of siloing, and absence of alignment or controls.	» Gap in oversight allowing opportunity to hide malpractice by CEOs or co-founders. » Failures in financial management\losses due to inadequate oversight across departments.
5.6 Lack of clear organisational culture shown by low adherence to values and lack of regular cadence of team meetings.	» Lack of leadership. » Lack of understanding of the value of culture. » Risks of non-aligned behaviour and actions.
5.7 Investors and board are too deferential to founder-CEO, e.g. they do not hold founder-CEO accountable for quality of reporting or missed targets.	» CEO is too dominant in decision-making. » A culture of accountability is lacking in the organisation. » The board meetings are mainly about reporting results, with little pushback or scrutiny with insufficient time to discuss strategy. » The board is ineffective and lacks a clear sense of how to guide the company.
5.8 Change of auditors which is sudden or unexplained, e.g. from reputable to unknown firm.	» Conflict between auditors and management may result from intent to conceal fraud or malpractice. » Auditors do not perform.

Remember – not all SMACS are ‘real’ warning signs

S	Suspicious information or behaviour
M	Missing pieces
A	Acute delays
C	Conflicts or complaints
S	Shifting people and strategies

The green flagged column shows how there could be an innocent explanation for a warning sign in each category – hence the need to look deeper.

More info →

Equally, the red flagged column shows that there could be serious consequences for missing the sign.

Remember – not all SMACS are 'real' warning signs

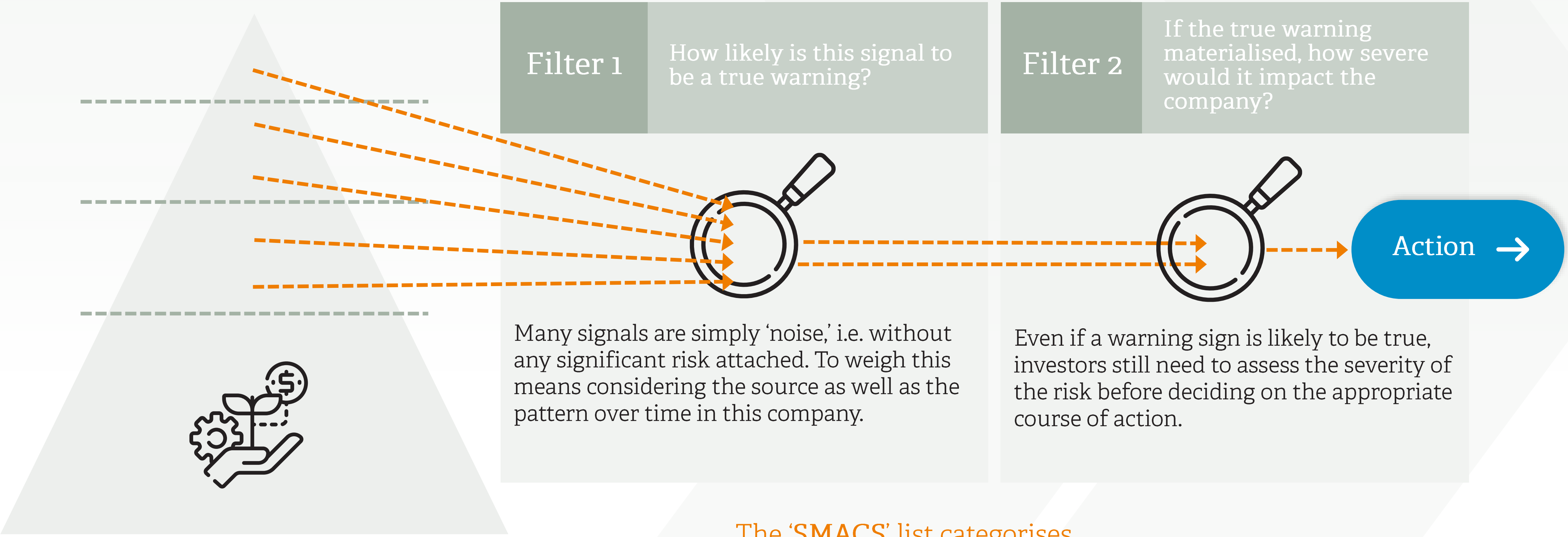
S	Suspicious information or behaviour	There could be alternative explanations for behaviour which do not involve malfeasance.	Equally, the red flagged column shows that there could be serious consequences for missing the sign. More info →
M	Missing pieces	There are legitimately different views about when or whether a particular policy or indicator is essential at this point in time.	
A	Acute delays	Particular circumstance warrants more time to resolve. Contextual issues such as staff changes or other priorities intervening.	
C	Conflicts or complaints	Not all conflict is bad – if well managed, it may even be constructive. Complaints are monitored as a basis for improvement in service.	
S	Shifting people and strategies	Pivoting is well-motivated and understood. Reasons for leaving are well understood and legitimate.	

Remember – not all SMACS are ‘real’ warning signs

S	Suspicious information or behaviour	- There could be alternative explanations for behaviour which do not involve malfeasance	- Manager/s are covering up non-performance. - Manager/s are committing fraud.
M	Missing pieces	- There are legitimately different views about when or whether a particular policy or indicator is essential at this point in time.	- Despite agreement about the need for a policy, control or indicator, it is not consistently implemented, raising questions of commitment.
A	Acute delays	- Particular circumstance warrants more time to resolve. - Contextual issues such as staff changes or other priorities intervening.	- Lack of competence or capacity around reporting. - Malpractice or fraud is being concealed. - Undisclosed financial stress.
C	Conflicts or complaints	- Not all conflict is bad – if well managed, it may even be constructive. - Complaints are monitored as a basis for improvement in service.	- Failure to address issues may slow down decision-making. - There is little visibility around fixable errors. - Conflicts driven by collusion.
S	Shifting people and strategies	- Pivoting is well-motivated and understood. - Reasons for leaving are well understood and legitimate.	- Shifts may indicate a lack of Founder/CEO competence or judgement. - Company trying to conceal key plans/information from investors. - The company culture is toxic, making it hard to attract and retain staff.

Reading the signals

A startup company sends out a **stream of signals about its condition and performance**. It takes time and effort to monitor all these signals. Investors cannot afford to waste time by taking action based on false signals. To avoid wasting time and resources, investors can learn to filter the signals to look for true warning signs of increased risk, which may require action.



Many signals are simply 'noise,' i.e. without any significant risk attached. To weigh this means considering the source as well as the pattern over time in this company.

Even if a warning sign is likely to be true, investors still need to assess the severity of the risk before deciding on the appropriate course of action.

The '**SMACS**' list categorises common warning signs to look for.

Taking action

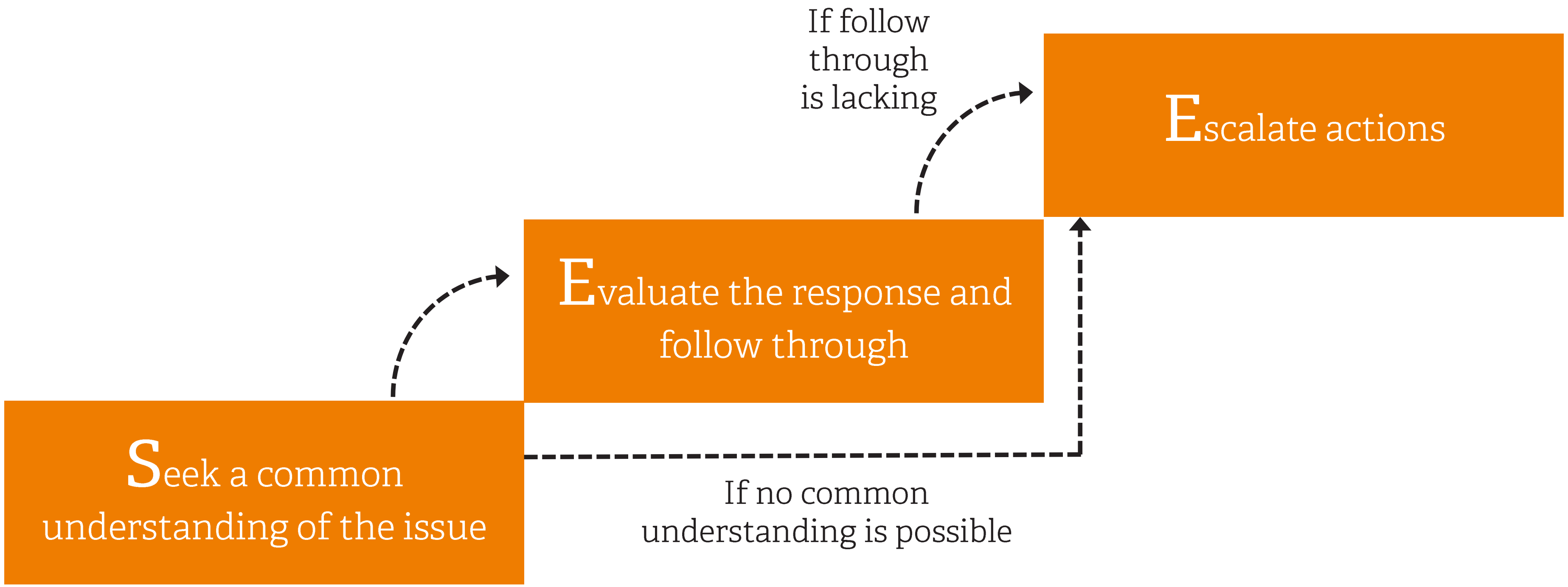
List of potential action steps

If a signal remains after applying both filters, it requires action proportionate to the risk. The appropriate steps to take will vary depending on the cause. Click on the link above to download a table of potential high-level actions to take following the different warning signals.

However, investors should **SEE their way to take the sequence of steps outlined on the next page**.

While investors and even non-executive directors may have limited influence to address the cause of a red flag, the failure of a director to act diligently and prudently following a warning sign may expose them to liability for loss if other shareholders or creditors pursue legal action.

Taking action



Taking action

Seek a common understanding of the issue

Find out: Do the CEO and other board members see the issue the same way? If not, what am I missing?

Evaluate the response and follow through

Ask: How do the CEO and/or other directors address the issue? Defensively? Evasively? Decisively?
Then: What action do they agree to take, and over time, have they done what they said they would?

Escalate actions

Ask: What powers do I have to enforce action if it is lacking, e.g. in an investment agreement? Is it time for an independent investigation? Can I convene a board or shareholders meeting to consider resolutions to address it? Do I still have confidence in the CEO or does the CEO need to be replaced?

If no common understanding is possible

Case 1

GoHardy, India

Listen in as a fund manager on the board of an investee, a fast-growing e-commerce company which has raised its Series A, attends a board meeting. Which warning signs does he hear?

GoHardy, India

GoHardy is a B2B e-commerce company for household hardware, which was started by two co-founders in India in 2019. In 2022, it raised $4.8m in a Series A round, which brought two VCs into the shareholding structure, each with a board seat.

Founders	**Atul Nayak** (CEO, 31 years old) **Amit Basak** (CTO, 30 years old)
Investors	Co-founders (51%) Northwaze Ventures (21%) Local Angels (15%) Oriyon Partners (13%)
Board composition	**Hari Sahu**, Chair (prominent local businessman and angel, recently appointed). **Atul Nayak**, CEO **Amit Basak**, CTO **Ranjit Patel** (appointed by Northwaze) **Parvati Panjul** (appointed by Oriyon) In attendance: **Meera Shah**, CFO (appointed in 2022)

Instructions

Imagine that YOU ARE Ranjit Patel, a director at Northwaze Ventures who sits on the board of GoHardy.

Continue

This case study is fictitious and is not based on any BII or FMO investment.

1

Audio 1 of 4

S
Suspicious information or behaviour

M
Missing pieces

A
Acute delays

C
Conflicts or complaints

S
Shifting people and strategies

Read the audio transcripts about a board meeting that Ranjit attended. The story has been divided into four segments.

While reading, consider if you pick up any of the possible warning signs relevant to the SMACS categories shown alongside.

1

Audio 1 of 4

TRANSCRIPT

Ranjit Patel glanced down at the GoHardy board papers on his iPad. As a director at one of India's leading domestic VC firms, Northwaze Ventures, who sat on several startup boards, Ranjit was used to reading board packs. Still, he felt a little unprepared for this particular board meeting since he only received the board pack yesterday. Indeed, he had only arrived late the night before – he had had to squeeze this board meeting into his busy travel schedule after it had been postponed from the previous month.

Still, there was much for the board to celebrate: GoHardy, the B2B marketplace platform for household hardware, was reporting stellar growth in its fourth year of operations. The financials told a familiar story, like other startups he knew in other sectors of the Indian economy as the digital wave took hold: Gross Merchandise Value had quadrupled year-on-year. The number of small hardware stores which had bought something on GoHardy's platform at least once in the prior month had doubled to reach 1450. The CEO report gave more background on these impressive numbers and noted that this was just the start of the next growth wave. The upbeat tone of the report was characteristic of Atul Nayak, the founder and CEO. Ranjit had come to know him reasonably well in the 18 months since Northwaze had invested in GoHardy's Series A round. This stake had led to the board seat, which Ranjit now filled.

The CEO report in the board pack now in front of Ranjit set out ambitious goals for GoHardy in this new year. An important item on the agenda for this board meeting was to agree on the draft term sheet for a Series B funding round within the next six months. Ranjit knew from quarterly cash forecasts that a cash injection was needed to fuel the intended growth. The proposed fund raise of $45m was a steep climb on the $4.8m they had raised in a Series A round the previous year, but the valuation was not out of line with norms in other pitch documents, which Northwaze was seeing from companies in growth mode.

GoHardy, India

1

Audio 1 of 4

S Suspicious information or behaviour	Mmm, no evidence yet – keep listening.
M Missing pieces	Mmm, no evidence yet – keep listening.
A Acute delays	Yes, the board pack was late and the board meeting itself delayed by a month.
C Conflicts or complaints	Mmm, no evidence yet – keep listening.
S Shifting people and strategies	Mmm, no evidence yet – keep listening.

This case study is fictitious and is not based on any BII or FMO investment.

1

Audio 1 of 4

S	Suspicious information or behaviour	Mmm, no evidence yet – keep listening.
M	Missing pieces	Mmm, no evidence yet – keep listening.
A	Acute delays	The delays could simply result from one-off events like a staff member being sick or otherwise occupied. OR they could signal a lack of capacity in accounting, OR a lack of priority being given to this area, which could lead to lapses or an orchestrated delay in order to cover up fake transactions.
C	Conflicts or complaints	Mmm, no evidence yet – keep listening.
S	Shifting people and strategies	Mmm, no evidence yet – keep listening.

2 Audio 2 of 4

TRANSCRIPT

However, before the term sheet, the first major item on the board agenda was to approve the annual financial statements for FY2022. These were the first set audited by the new audit firm. Last year, this firm replaced the original local accounting firm, which could no longer cover the scale of GoHardy's operations. However, the new auditors had taken longer than expected.In fact, the delay in the audit's finalisation was the reason for postponing the board meeting by a month. Ranjit did not recognise the name of the firm and had not yet met the new audit partner, but he took comfort in the fact that at least a new set of eyes had been applied to the financials. Perhaps the delay meant that they were being thorough. That, together with the appointment six months before Meera as full-time CFO, should help resolve some of the issues in the previous year when some of the numbers in reports supplied to the board had been inaccurate and had to be re-stated. As Ranjit had reviewed the draft financials, it occurred to him that GoHardy would benefit from setting up an audit committee. This committee would create an opportunity for board members to meet the auditors and to raise questions in more detail, like the items which had caught his eye while reading on the plane yesterday.

So, when the chair opened the discussion of the annual financial statements, Ranjit was quick to raise his hand: 'Chair, I think we should consider appointing an audit committee which could review the annual financial statements and recommend adoption to the board.' He noticed that Parvati, a partner in a VC firm which had co-invested with Northwaze, gave a slight nod to this proposal.

But Atul was quick to respond. 'Consider, yes, you are right, Ranjit – indeed, this we should be considering. That could be very helpful indeed in future. But not right now. Please I am asking you - coming out of the audit, we are now so busy with the fundraising plans that Meera and I just do not have time for another meeting.' Here, he looked across at Meera, who nodded emphatically. Ranjit had seen her at previous meetings, and she seemed competent, although perhaps a little too much under Atul's influence.

GoHardy, India

2

Audio 2 of 4

S Suspicious information or behaviour	Yes, we hear that there have been issues in the past with inaccurate numbers in board packs, leading to the need for restatement.
M Missing pieces	Yes, the fact that a company at this stage does not have an audit committee may be a warning sign.
A Acute delays	Yes, there have been other delays: now we hear about late Annual Financial Statements.
C Conflicts or complaints	Mmm, maybe some brewing but not yet – keep listening.
S Shifting people and strategies	OK – what specifically did you pick up? The fact that Meera, the CFO was new? That may not in itself be a warning sign – it may even be positive that GoHardy is hiring a full-time CFO.

This case study is fictitious and is not based on any BII or FMO investment.

2 Audio 2 of 4

S Suspicious information or behaviour	This could be in the past – after all they now have a CFO. However, this may signal a culture of not paying much attention to accuracy and accounting or worse, financial mismanagement. Something to watch for sure!
M Missing pieces	Accounting and risk issues do not receive the attention they deserve at main board meetings, which are always crowded with other items demanding attention.
A Acute delays	We hear that the auditors are new and also not a firm recognised by Ranjit, so maybe they are inexperienced and underestimated the time required. But it could also mean that they were conflicted, unsurfaced significant issues, and management and auditors failed to agree.
C Conflicts or complaints	Mmm, maybe some brewing but not yet – keep listening.
S Shifting people and strategies	OK– what specifically did you pick up? The fact that Meera the CFO was new? That may not in itself be a warning sign – it may even be positive that GoHardy is hiring a full-time CFO.

3 Audio 3 of 4

TRANSCRIPT

Ranjit didn't want to be seen as the one introducing bureaucracy, which could slow down the engine of growth, especially if none of the others spoke up. 'Well, I appreciate the need to prioritise, but maybe we can return to this matter after the B round completes. Chair, for now, I have just a few small questions about the annual financials.'

'Yes, certainly, but let's be quick about it,' the Chair said briskly. 'We have a lot to cover today, and with everything going so well, I know that Atul is wanting us to focus our time on the term sheet for the 'B'. You know what the B stands for, don't you?' He looked around the board table expectantly, then laughed. 'Big, and that's where Atul is taking this business – the big time.'

Ranjit smiled politely along with the others. He didn't want to sound unenthusiastic, out of sync with the optimistic tone in the room. 'We at Northwaze certainly value and respect the great efforts of Atul and his team to generate all this momentum. So, quickly then, let me ask: First, on the Balance Sheet, I was surprised to see a line for stock, which seems to be financed by the growing creditors. I thought our business was a platform which connected wholesalers to distributors but didn't hold any physical stock?'

'Ah yes, Ranjit, you are right: I should have explained this to the board before.' Atul sounded appropriately remorseful. 'This new entry is something which our new auditors forced us to do, but we fought them, didn't we, Meera? We realised last year that some of the new merchants needed help to get started, so we introduced a deal whereby we bought their stock for them, delivered it and then let them pay us when they sold it. It was like a special offer to help them get going. But really, we knew these people and also what sells well, so for us, it was like a done deal when we delivered orders to the shop. But the auditors insisted that we could only book a sale when the buyers paid, which seemed crazy to us. So we eventually agreed to a compromise – that we would book the sale on delivery, but if it was not paid within 14 days, then it would be reversed and treated as our stock. Makes sense, no? Think of it like a special sales incentive.'

Ranjit was surprised that this switch from a B2B platform to a kind of e-tailer of hardware had happened without any board discussion or agreement. It carried potential implications for an asset-light business model. However, it did sound like a form of special incentive, and he was relieved that the auditors at least had noticed it. But he had also noticed the other board members accepting Atul's explanation, so he decided not to push the question further. He noted that co-founder Amit was silent as he usually was in board meetings – he seemed to pay little attention except when issues came up around the IT platform, which was his sole responsibility.

GoHardy, India

3

Audio 3 of 4

S Suspicious information or behaviour	Yes, treating goods not yet sold as if the sale was already done and then glossing over it. The CEO made it sound like the conventional treatment of stock was unusual or inappropriate.
M Missing pieces	Mmm, no evidence yet – keep listening.
A Acute delays	Mmm, no evidence yet – keep listening.
C Conflicts or complaints	Yes, it sounds as if there may have been some conflict between auditors and the management.
S Shifting people and strategies	Yes, the apparent pivot in strategy from a tech platform for buyers and sellers to holding its own stock seems to have happened without board discussion or knowledge.

This case study is fictitious and is not based on any BII or FMO investment.

GoHardy, India

3 Audio 3 of 4

S Suspicious information or behaviour	This could reflect a lack of understanding by the CEO but since the CFO was also involved, it suggests at least that a coverup may be taking place.
M Missing pieces	Mmm, no evidence yet – keep listening.
A Acute delays	Mmm, no evidence yet – keep listening.
C Conflicts or complaints	The auditors may not fully understand the nature of the risk or the history, but if they are experienced, then it is more likely that management may be incompetent or else covering up.
S Shifting people and strategies	At the very least, the board is not being kept informed, nor is it at the centre of reviewing and approving strategy shifts, which may have a material implication on the balance sheet and funding needs.

This case study is fictitious and is not based on any BII or FMO investment.

4 Audio 4 of 4

TRANSCRIPT

Ranjit moved on. ‘Ok, I get it. I am sure you will carefully track this issue in future management accounts. My second question was about our wholesalers. With our sales volume growing like this, I expected that we might see a lot more wholesalers coming to our platform. But in the notes to the financials, I see that there was just one new one last year, Hardware Stack, which is already as big as all the prior ones in terms of sales. Are there any risks that we become too dependent on one supplier? If so, how do we know that our buyers will get the best deals?’

Atul glanced across at Meera briefly before he replied. ‘No, not at all. Hardware Stack came on the platform last year. The CEO is a cousin of Meera’s, and so we made her our account manager - for them, she’s the secret sauce behind why it’s going so well.’ He smiled at her. ‘And we have heard no complaints from our buyers about lack of stock selection or pricing. Those sales numbers tell the story of many happy customers.’

‘Yes, well, that is all good, but it reminds me - I also wanted to ask about customers. I know we do not yet have a general whistleblower line, but shouldn’t we be at least tracking and reporting customer complaints?’

Atul grimaced slightly and looked at the Chair, who cleared his voice and responded. ‘I am thinking that the excellent sales numbers are all the proof that I need that our customers are liking us and not complaining.’ With a glance at his watch, he said, ‘But we are needing to move on. Unless there are any more questions, I will move that the board recommends adoption of the annual financials to shareholders.’ He glared around the table, daring other members to ask any further questions. Ranjit was about to underline again the need to set up an audit committee to consider detailed issues like this for next year, but reading the impatient tone of the Chair and not wanting to feel like the bureaucrat in the room, he bit his tongue.

‘All those in favour of approving the annual financial statements, raise your hand.’ Four hands went up quickly. Ranjit felt the eyes of the room focused on him. Reluctantly, slowly, his hand went up. ‘It’s unanimous, then.’ The tension in the room visibly relaxed. The Chair then moved the meeting onto the fundraising plans for the Series B round.

GoHardy, India

4 Audio 4 of 4

S Suspicious information or behaviour	Mmm, there is no evidence in this segment.
M Missing pieces	Management says that customers are not complaining but since there is not yet a mechanism to monitor customer complaints, we do not really know.
A Acute delays	Mmm, there is no evidence in this segment.
C Conflicts or complaints	The largest seller on the platform came through a personal family connection with the new CFO.
S Shifting people and strategies	Mmm, there is no evidence in this segment.

This case study is fictitious and is not based on any BII or FMO investment.

4

Audio 4 of 4

S Suspicious information or behaviour	Mmm, there is no evidence in this segment.
M Missing pieces	Management and board do not really know about bad experiences from customers.
A Acute delays	Mmm, there is no evidence in this segment.
C Conflicts or complaints	The deal may be entirely above board, but did Meera declare her family relationship before engaging with them? If not declared, that would be a breach of policy, and even if it was, if this important business relationship is not well managed, the conflict of interest could prejudice GoHardy's interests. However, since we hear that Meera is also managing the commercial relationship for GoHardy, the risk of this is greatly heightened. She may be getting a cut or kickback on the sales.
S Shifting people and strategies	Mmm, there is no evidence in this segment.

This case study is fictitious and is not based on any BII or FMO investment.

Warning signs you picked up

S Suspicious information or behaviour	The CEO's answers relating to the stock issue were not clear and consistent. There have been previous issues with inaccurate information supplied to the board.
M Missing pieces	There is not a mechanism to monitor complaints yet – so we do not know.
A Acute delays	Delayed Annual Financial Statements and late board pack. Delayed board meeting.
C Conflicts or complaints	Possible conflict with the auditors. Possible undeclared conflict of interest between CFO and the major supplier.
S Shifting people and strategies	The change in strategy from platform to holding own stock seems to have happened without board discussion, knowledge or approval.

Now, let us review all the warning signs together.

Ranjit needs to assess each one as to how urgent it may be in order to prioritise actions.

Consider how you would rank each category of warning signs in terms of how urgently you think he should follow-up:

High: He needs to act immediately.
Medium: That he should act before the next meeting.
Low: He should watch and see more evidence before acting.

GoHardy, India

GOHARDY

	Warning signs you picked up	*Urgency level*	What could this mean?
S Suspicious information or behaviour	The CEO's answers relating to the stock issue were not clear and consistent. There have been previous issues with inaccurate information supplied to the board.	HIGH	**High:** This approach shows, at best, a lack of understanding and may also overstate revenue in the AFS in ways which are misleading and inconsistent.
M Missing pieces	There is not a mechanism to monitor complaints yet – so we do not know.	MEDIUM	**Medium:** It would be good practice now to put a complaints process and whistleblowing policy in place and then report regularly on trends to the board.
A Acute delays	Delayed Annual Financial Statements and late board pack. Delayed board meeting.	HIGH	**High:** For the AFS at least; **Medium** for the late board packs and delayed meeting as the board protocols could be discussed before the next meeting.
C Conflicts or complaints	Possible conflict with the auditors. Possible undeclared conflict of interest between CFO and major supplier.	HIGH	**High:** The conflict with auditors may compromise their ability to access information and form independent judgements, and an undeclared personal interest in a key relationship may indicate collusion and would also be a violation of company policy, which could expose the company to commercial and financial risk especially if there is collusion.
S Shifting people and strategies	The change in strategy from platform to holding own stock seems to have happened without board discussion, knowledge or approval.	HIGH	**High:** The implications for the business of this pivot are quite material when about to embark on fundraising: the rationale and approach need to be agreed upon among directors and then stated explicitly. Not doing so bypasses governance controls and may even be a breach of the shareholders' agreement.

GoHardy, India

Remember, individual warning signs may seem small and inconsequential, but you should step back to consider the bigger pattern before deciding what courses of action to take.

GoHardy looks on the surface like a successful, fast-growing company, but this pattern of warning signs suggests that there could well be malpractice and even malfeasance by the management – deliberate as well as unintentional. Ranjit has good reason to move quickly on this one.

	Warning signs you picked up		What could this mean?
S Suspicious information or behaviour	The CEO's ans issue were no have been pre information s		anding and may also eading and
M Missing pieces	There is not a complaints ye		plaints process and arly on trends to the
A Acute delays	Delayed Annu late board pac Delayed boar		packs and delayed fore the next meeting.
C Conflicts or complaints	Possible confl Possible unde between CFO		eir ability to access an undeclared personal and would also be a company to llusion.
S Shifting people and strategies	The change in strategy from platform to holding own stock seems to have happened without board discussion, knowledge or approval.	HIGH ↓	High: The implications for the business of this pivot are quite material when about to embark on fundraising: the rationale and approach need to be agreed upon among directors and then stated explicitly. Not doing so bypasses governance controls and may even be a breach of the shareholders' agreement.

Now what are Ranjit's options for action?

Ranjit has clearly picked up some worrying signs within a possibly larger pattern. The board does not seem to take his questions or concerns seriously. To take action, he must carefully consider how to press his points.

Since all directors and shareholders have an interest in a successful upcoming Series B round, this planned event could give him the leverage to propose immediate, specific actions in preparation for that.

Possible actions he could take in each case

This case study is fictitious and is not based on any BII or FMO investment.

Warning Signs	Possible actions he could take in each case
Delayed financials and associated questions about the accounting treatment of stock.	» Request to meet auditors directly ASAP and also to see their management letter. » Assess their competence through a background check on their client portfolio and asking around. » If still concerned, he could request a special board meeting and even a special audit by another firm.
Late board pack and delayed board meeting.	» Discuss and affirm with the Chair the need for an annual meeting calendar and a clear protocol for when and how a board meeting is postponed. » However, since the Chair seems ineffective and conflicted, discuss with other investors and with the CEO the need for a chair who is able to win the confidence of likely Series B investors.
The **change in strategy** from platform to holding own stock seems to have happened without board discussion or knowledge.	» Discuss with the CEO and Chair the issues which need board discussion first – if this is not clear already, then approve a new delegation of authority matrix indicating which issues only the board can decide. » Convene a special board meeting to discuss the implications of this shift before finalising the Series B term sheet.
There is **no complaint-handling process** or whistleblower policy.	» Propose to the CEO or formally at the next board meeting that a complaint system and whistleblower process be implemented and monitor its adoption.
The **personal relationship** between the CFO and the major supplier should have been declared.	» Ask to see the register of interests of officers to see if this was recorded; if not, propose disciplinary action. » Discuss with the CEO the need to install additional safeguards and oversight in this relationship, such as her recusing from decision-making about this contract and additional checks done over invoicing terms during the audit; if he does not accept this, escalate the issue to the Chair and/or other shareholders.

How might other investors handle this situation?

GIULIA

Partner in a VC investor

JASPER

Associate at a VC fund

This case study is fictitious and is not based on any BII or FMO investment.

GoHardy, India

How might other investors ha

GIULIA

Partner in a VC investor

‘If I were in Ranjit’s shoes, I would feel very uncomfortable after this meeting: he raised some important questions, which I would also have done, but they were essentially ignored, and no-one else on the board even seemed to care. He comes across as if he has no influence to push harder to get answers on some of these, but he has influence as a board member, and should have enquired further. But frankly, I also know that the culture of some boards makes it very hard to go against the flow and seem to question the judgment of the CEO, especially when the company seems to be very successful.

Of course, the Chair should be the key board member with whom Ranjit should pick up his questions, but the Chair sounds like a bit of a washout who is out of his depth. So I would first follow up immediately afterwards with the other VC on the board, Priyanka, to see whether she agrees with his concerns even though she remained silent at the time. In fact, I probably would have discussed it with her in advance if the board meeting had not been delayed and then rushed.

Together, we would have more leverage and could set up a meeting with Atul as soon as possible to stress the need to take the accounting and strategy issues very seriously as matters for the board to discuss again and agree on because any new investors in the next round would be looking into these things; and would run a mile away if they felt issues were not resolved.’

GoHardy, India

How might other investors handle this situation?

GIULIA
Partner in a VC investor

JASPER
Associate at a VC fund

GoHardy India

'Giulia's advice may sound logical and even collegial when trying to work with the co-investor, but it misses the point that there is good reason to have substantial concerns about the accuracy of the annual financial statements on which new investors will rely, and if the statements turn out to be materially misstated or even fraudulent in worst case, new investors may hold the current board liable.

So, I think it is a much more serious situation which needs urgent action. With or without Priyanka, I would immediately request to speak to the auditors with the CFO present to discuss my questions. I would definitely want to see the audit letter. If I had not done this back when they were appointed, which would have been an oversight, I would check out the auditor's track record first by asking around. If the meeting confirms the discomfort, I would call for another board meeting to revisit the decision to recommend.

Also, let us not lose sight of the possibility that the new CFO Meera may not have enough authority or independence from the CEO, so I would want to understand better how she thinks and acts – does she hold her own opinions, for example? Does the board listen and invite them?'

JASPER

Associate at a VC fund

GoHardy, India

How might other investors handle this situation?

GIULIA

Partner in a VC investor

JASPER

Associate at a VC fund

This case study is fictitious and is not based on any BII or FMO investment.

Managing crises

The failure to see or act on a warning sign may lead to a crisis in a company. A crisis is a risk event which threatens the life of the company. Such crisis **may be driven by various forms of risks – including operational risks, which threaten business continuity; Business Integrity (BI) risks** (see the box below), **environmental and social risks such as retrenchment.** These may result in regulatory or criminal action, which carry the risk of regulatory and criminal action, reputational damage, and negative impact on financial and commercial performance.

Business integrity risks

Business integrity (BI) risks are a particular category of risks that, if mismanaged, can have serious regulatory or reputational repercussions as well as negative impact on a company's financial performance and resilience. If in fact, an incident has taken place, there can be severe consequences for a company as well as its directors and officers. Such risks may include:

- Bribery and corruption (incl. conflicts)
- Fraud
- Money laundering
- Terrorism financing
- Breaches of sanction regimes
- Tax evasion
- Whistleblowing
- Data protection and cybersecurity

Even the allegation that there has been a BI incident at a portfolio company may trigger the need for crisis management by the company and its investors because of potential reputational and regulatory risk exposure.

You can read more specific guidance about BI risks at both fund manager and portfolio company levels in this publication here.

Managing crises

Crises can also result from **risks which could not have been reasonably foreseen**. Regardless of the trigger, a company needs to have a crisis management plan which can be activated when a crisis occurs or is imminent.

A crisis management plan comprises these elements*:

- Engages a cross-functional team for planning and execution who are in regular contact with the board or a designated member or committee.
- Identifies crisis management leaders.
- Provides guidance on communication strategies internally and externally.
- Delineates responsibilities very clearly, including that of the CEO and board in the crisis.

The board of directors is responsible for ensuring that a company takes a strategic and active approach to risk management, though it is the task of management to implement an effective risk management system. If they are not represented on the board, **investors are not responsible for overseeing risk, but they should monitor how effectively boards perform this role.** Note that some crises may require the Chair and/or other non-executive directors to step up at short notice and allocate much more time to addressing the crisis.

Note that directors may carry personal liability arising from a breach of their fiduciary duty to the company or from contravention of law or regulation. For example, directors may be held liable for fraud at a company if it is shown to result from a failure to apply oversight. Creditors, staff or newer investors who suffer loss arising from a crisis or failure may hold investors who had the power to act liable for their failure to act.

*Read the FMO paper *Risk and crisis management – the role of good corporate governance*, available here.

Case 2

PayJ, Kenya

A fund manager on the board of a FinTech company receives a call from a journalist. What should she do?

PayJ, Kenya

PayJ is a Kenyan FinTech company which was started by Stephen Mugo in 2017. It specialises in providing digital payment services to employers linked to the provision of payroll management software for a fee.

PayJ raised a series A round in 2021 in which several VCs, including KWC Ventures, took stakes. Partner Kelly Wambui sits on the board.

With the proceeds of the Series A round, PayJ has since diversified into digital lending through a recent joint venture with a fast-growing local FinTech called DigiLoans.

Instructions

Imagine that YOU ARE **Kelly Wambui,** Partner KWC Ventures.
As you listen, think about how you might respond.

Continue

This case study is fictitious and is not based on any BII or FMO investment.

1

Audio 1 of 2

Corruption, fraud and bribery

Money laundering and terrorist financing

Breaches of sanctions regimes

Regulatory risks

Reputational risks

Read the transcript for the first audio clip.

In the story so far, consider which of these categories of risk you hear emerging.

1 Audio 1 of 2

TRANSCRIPT

'Hello. May I speak to Kelly Wambui of KWC Ventures?'

The caller's voice sounded vaguely familiar to Kelly. 'Yes, this is she,' she responded crisply.

'This is Paul Ngugi, The Daily Nation.'

'Oh, Paul, yes – I remember meeting you at the Africa FinTech conference last year.' An edge of caution entered Kelly's voice. She always felt tense dealing with journalists.

'I interviewed you after your panel at that event. But today, I would like to ask a few questions about PayJ. May I confirm that your fund is an investor in PayJ and also that you personally hold a seat on its board?'

'Paul, I'm sure you have already checked on our website that our FinTechOne Fund invested in PayJ's Series A in 2021, and I have served on the board since then.'

'So then, can I ask for your comment on the news that the Central Bank of Kenya is likely to launch an investigation into whether PayJ has violated the conditions of its payment service provider license as a result of launching its digital lending business without securing approval?'

This was indeed news to Kelly. Her mind reeled at the consequences of a regulatory inquiry – both for PayJ and for the reputation of her new fund.

'Um, well, I don't have a comment at this stage – you really should speak to PayJ.'

'I have tried, but the CEO has been stonewalling me. And I thought since last year at that conference you were so outspoken about the need for proper regulation in Kenyan FinTech that you might be more forthcoming.'

Continued to next page...

1 Audio 1 of 2

TRANSCRIPT

Continued from previous page…

'Well, yes, that's true. We at KWC believe strongly in the need for proportionate regulation in this sector and have welcomed the CBK's efforts to clean up digital lending.'

'Our readers will be reassured to hear that, but it looks like someone didn't follow all the right regulatory approval procedures before PayJ announced its new joint venture with DigiLoans. And it also seems that DigiLoans has a history of not taking customer complaints seriously. I have recorded interviews with several borrowers who allege that it charges exorbitant interest rates and follows oppressive collection practices.'

'Well, Paul, I'm sure that there's an explanation – you know, disaffected borrowers under stress…' her voice trailed off.

'But it doesn't end there, Kelly. While investigating this story, we recently received an anonymous tip-off that the brother of PayJ's CEO's wife has an interest in DigiLoans, held through a trust. Are you aware of this?'

Kelly's heart skipped a beat. She rapidly thought back several months to the PayJ board meeting at which the JV had come up for approval, but she couldn't recall the CEO Stephen Mugo making any such disclosure. She hoped she was wrong. But right now, she needed time to get the facts right.

'Paul, I appreciate your reaching out to me. I really have no comment right now, but I can assure you that we at KWC take very seriously our own reputation and also the good standing of our investees. May I come back to you by tomorrow?'

'OK, but you should know that my editor has set a deadline for this story to run in Wednesday's edition. So if I don't hear back from you or PayJ before tomorrow afternoon, we will simply add a line stating that PayJ and its VC backer KWC were approached for comment but had nothing to say.'

PayJ, Kenya

1 Audio 1 of 2

Corruption, fraud and bribery	Not yet as far as we know – but keep listening.
Money laundering and terrorist financing	No – not in this story, as far as we know.
Breaches of sanctions regimes	No – not in this story, as far as we know.
Regulatory risks	Yes, we hear that the financial regulator may be about to investigate PayJ as a result of its involvement with DigiLoans, although the facts are not very clear yet.
Reputational risks	Yes, clearly the news of the complaint could damage the reputation of KWC Ventures in the local ecosystem, as well as with its international investors.

This case study is fictitious and is not based on any BII or FMO investment.

1

Audio 1 of 2

So, is this a crisis? If so, for whom?

- No
- Yes, but mainly for PayJ
- Yes, for both

PayJ, Kenya

1

Audio 1 of 2

So, is this a crisis? If so, for whom?

No	Really? The journalist is about to publish an article alleging several regulatory and ethical breaches. Even if they are not true, the story alone could damage both PayJ and KWC Ventures' reputations.
Yes, but mainly for PayJ	Even if the allegations about PayJ do not stick, Kelly, as a director of and investor, faces reputational risk in the market, so it is not only about PayJ.
Yes, for both	Yes – in addition to the issues which PayJ faces, as an investor and board member, KWC Ventures also faces a crisis which will affect its reputation with regulators and LPs.

This case study is fictitious and is not based on any BII or FMO investment.

2 Audio 2 of 2

S Suspicious information or behaviour

M Missing pieces

A Acute delays

C Conflicts or complaints

S Shifting people and strategies

Read the transcript from the second audio clip on the next page.

When Kelly reflected on what had happened, did you pick up any of the SMACS warning signs that a crisis like this might erupt?

2

Audio 2 of 2

TRANSCRIPT

Kelly disconnected the call and exhaled. Phew! That felt like an ambush. Why hadn't Mugo called her to let her know this was coming? She glanced at her phone and saw several missed calls earlier from him. But how much did he know about all this?

Her mind went back to the PayJ board meeting at which the joint venture with DigiLoans had been approved. She remembered the triumphal spirit in which Mugo had presented the deal, which the board had caught and shared. It was seen as a coup to be celebrated. She remembered asking a few questions — mainly about how the profits would be shared and didn't recall many questions from other board members. She was sure that there had been a regulatory review of the deal in the board pack, which suggested that all was in order to proceed. She was well aware that the regulatory environment around digital credit, in particular, was still evolving, but that was DigiLoan's issue, surely, not PayJ's. And as for Mugo's family having an interest in the other party...

She jabbed the redial button on her phone.

'Kelly!' Mugo's voice was firm and clear.

'Mugo, what is going on? I have just had that Daily Nation reporter on the line, asking for comment about a possible CBK investigation of our deal with DigiLoans.'

'Yes, he also tried to reach me earlier, but I wanted to check a few things out before speaking to him.'

'Well, you could at least have let me know — with our public stance about regulation, you could have guessed that he would try to get in touch with me. I didn't give him any comment, but I said I would get back to him. So, what is happening?'

Continued to next page...

2 Audio 2 of 2

TRANSCRIPT

Continued from previous page...

'I have just spoken with our lawyers, the ones who did the due diligence for the JV, if you remember. They believe we have been compliant. But more importantly, the senior partner said that he had access to advisors who can easily persuade the regulator to drop the investigation.'

'Wait a minute. Persuade them...how exactly?'

'Kelly, I don't know. I just know that they have been very effective at getting us all the approvals we needed so far.'

'Mmm, I need to know more about this. But this isn't just a regulatory issue — he also mentioned allegations of bad practice made by clients of DigiLoans. Mugo, please assure me that you looked into their practices and complaints before recommending the deal.'

'Kelly, you saw the due diligence report. DigiLoans said they didn't yet have a formal complaint handling process since it wasn't yet a requirement, but they assured us that they had never had any major problems.'

'And you believed them? Surely you also asked around about their reputation?'

'Kelly, you know as well as I do that DigiLoans is well-regarded as the up-and-coming player in digital credit. Its name features at every FinTech event. Even with the general public, they announced their sponsorship of that new soccer stadium last month. That's why we were all..' here he slowed to emphasise the word 'so pleased that they were willing to work with us. I seem to remember you celebrating with all the rest of us.'

'Well, I hope we won't come to regret that early celebration.' She paused. 'Mugo, that journalist raised one other issue with me. He said that your brother-in-law has an interest in DigiLoans. Is that true?'

Continued to next page...

2 Audio 2 of 2

TRANSCRIPT

Continued from previous page...

There was another short pause. 'Is he referring to Matu? Of course, we checked DigiLoan's cap table, but I can assure you his name wasn't listed there.'

'No, not personally, but was there a trust listed among the investors? Did you check on the beneficial owners?'

'Kelly, you have to understand, there were lots of names on that cap table. I don't remember them all, but we got our law firm to check out the list. I'm sure they did their job. And you know that we were all so pleased about the JV, which sent such a good signal of our beyond payments strategy before our next fund raise; none of us wanted to slow things down for little details like that.'

'Little details...' She struggled to restrain the anger in her voice, although she knew that it came out of a growing fear. 'Mugo, we need to meet, with your lawyers present, now, this afternoon. Have you any idea how damaging this article alone could be for all of us? We need to know exactly what is going on here, and we need to be very clear about how we communicate with the media and with the regulator.'

PayJ, Kenya

2 Audio 2 of 2

S Suspicious information or behaviour	Yes! The law firm will 'persuade' the regulator to drop the inquiry. What does that mean – could it include payoffs/ kickbacks (i.e. corruption risk)? There is no clear sense of what has been violated and whether the accusation holds, so it sounds suspicious. Also suspicious is the response of the CEO, who sounds rather evasive in his replies to his investors and board members and seems to have lacked transparency in his past interaction with the board, as well as not complying with set corporate governance systems.
M Missing pieces	Yes, the decision-making process on the PayJ board regarding the Joint venture appears to have been defective: the due diligence was inadequate (the law firm sounds like it failed to conduct adequate inquiries) but also the board failed to ask questions to understand the risk fully. Also, as noted under complaints below, the lack of a customer complaints reporting system handicaps the ability to understand what is happening with customers.
A Acute delays	No, not in this case.
C Conflicts or complaints	Yes! There seems to be an undisclosed conflict of interest with Mugo's brother-in-law, who is an undisclosed shareholder in the other party. Also, the journalist refers to some customer complaints, although it sounds anecdotal — because there is as yet no system to log and monitor them, it is hard to know what to make of them.
S Shifting people and strategies	No, not evident in this case.

This case study is fictitious and is not based on any BII or FMO investment.

2 Audio 2 of 2

Clearly, the time must come for reflection at both KWC Ventures and PayJ about which signals were missed and which controls were missing and how to avoid this in future. But for now, Kelly has a crisis to manage and the journalist is awaiting her comment the next day.

S

Yes! The law firm will 'persuade' the regulator to drop the inquiry. What does that mean –
uspicious. Also suspicious is
es to his investors and
ast interaction with the
systems.

nt venture appears to have
sounds like it failed to
estions to understand the
ustomer complaints
appening with customers.

th Mugo's brother-in-law,
he journalist refers to some
se there is as yet no
make of them.

Shifting people and strategies

No, not evident in this case.

What should Kelly do?

She clearly needs to respond to this crisis, but she needs to balance her position as a director in PayJ who is statutorily obliged to pursue the best interests of the company with her position as a partner in a VC firm.

As in most crises, this one could play out in different ways over time. In particular, she needs to address the immediate issue of whether to comment to the media and then the follow-on issues about what is really happening at PayJ.

Prioritising responses →

This case study is fictitious and is not based on any BII or FMO investment.

Resign as the director of PayJ.

Understand the full basis of the regulatory complaint.

Propose that PayJ board commission an independent review into its decision-making and oversight of ethics.

Call a special PayJ board meeting to propose that the JV with DigiLoans be terminated.

Issue a separate press statement as KWC Ventures.

Agree to a media strategy with PayJ so that KWC is briefed about all releases before they happen.

Consider which of these responses Kelly might prioritise after she meets with the CEO and PayJ's lawyers.

Resign as the director of PayJ.	No – this would be hasty to do at this stage and would likely exacerbate rumours and uncertainties without yet having gone through a fair process to establish what went wrong and who was responsible.
Understand the full basis of the regulatory complaint.	Immediate priority - and it sounds like she may need to get a second legal opinion since the current firm may be compromised.
Propose that PayJ board commission an independent review into its decision-making and oversight of ethics.	Priority - there seems to be enough basis to consider this step, especially if she detects in Mugo more evidence of evasiveness.
Call a special PayJ board meeting to propose that the JV with DigiLoans be terminated.	No – until there is clear evidence of a basis for a breach of the agreement, cancellation could even lead to claims for damages.
Issue a separate press statement as KWC Ventures.	Possibly, if she detects that PayJ is taking a line, she cannot support it, but this may be premature until there is more clarity. Certainly, it seems worth getting back to the journalist with her understanding and commitments as part of indicating that she personally and KWC Ventures, as a fund manager, takes issues like these seriously but also does not act recklessly in advance of evidence.
Agree to a media strategy with PayJ so that KWC is briefed about all releases before they happen.	Immediate priority – going forward there should be no surprises between investor and investee, especially if the story leads to more media scrutiny. The board of PayJ should agree on a spokesperson if the circumstances mean that it cannot be Mugo.

How might other investors handle this situation?

HUMA
Partner in a VC fund

ROBERT
ESG specialist at a VC fund

This case study is fictitious and is not based on any BII or FMO investment.

How might other investors ha

HUMA

Partner in a VC fund

'I would focus on the regulatory issue here — what is it? What procedures exactly may have been missed, and if so, can it be remedied? After all, Kelly has been building her reputation as standing for good regulation in the sector, so if she does not pay attention to this, it will suffer.

I would also be concerned about whether the law firm advising PayJ is competent and ethically "persuading" a regulator to drop an investigation sounds a little dodgy to me and smacks of possible kickbacks involved. Surely, if they did the legal DD on the deal, they would just be able to stand on the outcome. I would advise Kelly to seek some independent counsel here once she understands the issue and maybe also ask around about the law firm's reputation.

And given that there seem to be additional issues at question here which point to some gaps, I would start raising the need for the board to do a more thorough review of ethics and regulatory compliance.'

PayJ, Kenya

How might other investors handle this situation?

HUMA
Partner in a VC fund

ROBERT
ESG specialist at a VC fund

This case study is fictitious and is not based on any BII or FMO investment.

'Wait, wait, wait! The regulatory issue may simply be a rumour, someone looking for leverage, or even a payoff – that can likely be resolved on the facts.

To me, the biggest issue here is that there is a big ethical question mark over CEO Mugo. His commitment to corporate governance sounds weak, too. Since it seems he did not declare any interest at the time of approval of the JV, I would want to ask him point blank: Did he know about his brother-in-law's investment in DigiLoans or not? If he did, this is a serious ethical failure, and I would propose a board reprimand at the very least. Maybe followed by a review of the conflict-of-interest policy and some compulsory training for management and staff. And even if he denies it, if I were Kelly, I would keep a close eye on the ethics at PayJ going forward.

Frankly, Mugo sounds rather evasive in the conversation with Kelly and not as concerned as I would expect about resolving these allegations if, of course, they are true, which we do not yet know. Also, their law firm does not sound great either since they reviewed the shareholdings and failed to pick up any issue – maybe it is time for a change of lawyers?'

ROBERT

ESG specialist at a VC fund

PayJ, Kenya

How might other investors handle this situation?

HUMA

Partner in a VC fund

ROBERT

ESG specialist at a VC fund

This case study is fictitious and is not based on any BII or FMO investment.

This is a real story...

FTX

- FTX was a cryptocurrency exchange controlled by its founder-CEO Sam Bankman Fried, founded in 2019. FTX raised $2.3 billion in equity funding from around 150 different VCs in four rounds in 2020/ 21, which gave these external investors a stake of 6%. At its short-lived peak in early 2022, FTX was valued at $32 billion.
- At the time of its rapid and spectacular collapse into bankruptcy in November 2022, it had more than ten million account holders.
- '[Bankman Fried] refused to give any investors a seat on the board or any other form of control over the business. This was largely because he questioned the need for a board of any sort: "It's unclear if we even have to have an actual board of directors," said Sam, "but we get suspicious glances if we don't have one, so we have something with three people on it." When he said this to me, right after his Twitter meeting, he admitted he couldn't recall the names of the other two people. "I knew who they were three months ago," he said. "It might have changed. The main job requirement is they don't mind DocuSigning at three a.m. DocuSigning is the main job.'
- Lewis: 'A lot of what got done inside Sam's world got done without the usual checks and balances. Others found it hard to complain too loudly. The deals seemed to involve only Sam's money: Why shouldn't Sam be able to do with it whatever he pleased? Still, there couldn't be many other cases in human history of a person his age tossing around dollars in the amounts he was tossing them without much adult supervision, or the usual constraints of corporate life.'

Quotations are drawn from Michael Lewis' 2023 book on Bankman Fried and the rise and fall of FTX called Going Infinite: the rise and fall of a new tycoon.

This is a real story...

FTX

- At its peak, the company had around 300 employees but never had an official organogram, and there was little role clarity as it grew. Resident psychiatrist George Lerner, who also served as an advisor to the CEO, drew up an unofficial org chart showing that up to 24 people thought they were reporting directly to Bankman-Fried. FTX had no Chief Financial Officer, Chief Risk Officer or Head of Human Resources. Lewis quoted Lerner saying, 'It seems like a clubhouse more than a corporation'.
- Except for a few roles (the psychiatrist and some lawyers), Michael Lewis reported that he encountered no employee with much experience in their roles other than the experience gained on the job at FTX.
- Only co-founder Gary Wang understood the IT systems which drove the trading of billions of dollars on the exchange, and he was left to work in a silo with no direct reports and with minimal contact with other staff.
- There was little or no effective control or reporting of financial flows with an affiliated company, Alameda Research, a private hedge fund which Bankman Fried also majority-owned. In addition, Bankman Fried had a romantic relationship with the person he appointed as CEO of this company, Caroline Ellison.
- Bankman Fried was convicted on numerous counts of fraud and conspiracy in November 2023, and FTX is being wound down after fewer than four years in operation.

The FTX story shows that **warning signs matter in any context**, not only in emerging markets. In this abbreviated real story, **did you hear any of the SMACS categories of warning signs** before the collapse?

S	M	A	C	S
Suspicious information or behaviour	Missing pieces	Acute delays	Conflicts or complaints	Shifting people and strategies

Takeaways

- **Good governance matters** for startup success.
- Investors, especially if they also serve as board members, need to **monitor and read ongoing signals** from portfolio companies to ensure that they understand what is really going on in the business.
- Look out for warning signs in the **'SMACS'** categories.
- Investors then need to **'SEE' their way to take appropriate and timely action** – failure to take action can lead to a crisis.
- Crisis management requires that there are **clear roles and protocols** for the board, management, and staff to follow.

Full list of warning signs

List of potential action steps

For further information

British International Investment plc:

123 Victoria Street
London SW1E 6DE
United Kingdom

T: +44 (0)20 7963 4700

E: Giulia Rigazio: grigazio@bii.co.uk
Huma Yusuf: hyusuf@bii.co.uk

bii.co.uk

FMO Ventures:

Anna van Saksenlaan 71
2593 HW, The Hague
The Netherlands

T: +31 70 314 96 96

E: info@fmo.nl

www.fmo.nl

British International Investment

FMO VENTURES