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Corporate Governance Challenges for India's Startup Ecosystem & Risks of Earning Mismanagement

Prof. (Dr.) Binod Pratap Singh[1] & Dr. Smriti Shishir[2]
[1]Professor & Head, Department of Commerce, Shri Lal Bahadur Shastri Degree College, Gonda, Uttar Pradesh, India
Dean, Faculty of Commerce, Maa Pateswari University, Balrampur, Uttar Pradesh, India
[2]Assistant Professor, B.B.A. Department, Shree Lal Bahadur Shastri Degree College Gonda
Email: - smritishishir9@gmail.com

Abstract:

India's start-up ecosystem has emerged as one of the most vibrant in the world, with more than a hundred unicorns spanning across several sectors, including fintech, edtech, e-commerce and SaaS. This exponential rise, while depicting unprecedented innovation and well-thought-out policies, including Startup India and Digital India, has also unveiled alarming concerns about corporate governance. In contrast to listed companies, a considerable proportion of Indian start-ups exhibit founder concentration, which is accompanied by low levels of independent board monitoring and underdeveloped internal audit mechanisms. These governance gaps serve as fertile ground for various forms of earnings manipulation, ranging from manipulating accruals and real activity to inflating operating statistics like user numbers or gross merchandise value.

Based on secondary evidence, academic research, and official data, the paper develops conceptual arguments supported by empirical case examples for the long-run decline in financial system efficiency and effectiveness, as well as a system weakened by structural problems and investor activism. Results emphasise that demand and valuation pressures during fundraising, IP stakes, and competitive positioning provide founders with strong economic incentives to misreport their performance. Industry-specific trends, including inflated enrolment rates in the edtech sector and overstated lending revenues in the fintech sector, highlight how weak corporate governance structures can create significant challenges. The study identifies three major limitations in the existing literature: a lack of empirical attention to start-ups, insufficient consideration of investor-driven reporting pressures, and an underestimation of sectoral vulnerabilities inherent in India's digital economy. These need to be addressed with the early inclusion of independent directors,

more stringent disclosure standards, in-house audit capabilities, and regulator-led monitoring post-IPO threshold.

Finally, the paper suggests that corporate governance should be developed in response to entrepreneur station demand. Sustainable scaling requires transparency, accountability, and a model of governance that minimises manipulation of earnings yet continues to foster creative dynamism. The key topics include corporate governance, start-ups, earnings management, India, financial reporting, and entrepreneurial ecosystems.

Keywords: *Ecosystem, e-commerce, Corporate Governance.*

1. Introduction

India has emerged as one of the most vibrant entrepreneurial landscapes, owed to its robust start-up ecosystem. Fuelled by digital, venture, and financial innovation and such forward-looking policies as Startup India and Digital India, over 100 unicorns emerged in the country's domestic market landscapes across fintech, edtech, health tech, and e-commerce domains ad infinitum while on an exponential path. 2 If the above arguments point to a successful scenario involving domestic marketspaces, placement of these is, however, fraught with many governance challenges. Unlike more established corporates, many start-ups exist in pressured environments where early scaling and revenue generation are key.

This is when other forms of earnings manipulation, "judicious change (up or down) in financial reports to show favourable performance," can become useful tools for founders chasing the last investor, valuation, or funding round (White 2005). While earnings management is not necessarily fraudulent, it creates a lack of transparency and dependability in financials depending on the level of manipulation, which can undermine investor confidence and future growth opportunities for a company.

Corporate governance of startups in India is still in nascent stages. One is they tend to have loose governance frameworks, often with considerable power residing in a founder and lacking the heavy-duty board oversight of most (public) companies. Lack of an independent board, a delayed internal audit system, and big freedom from regulators create earnings management venues.

The paper seeks to investigate the confluence of governance vacuum and potential for earnings mismanagement in the Indian start-up environment. The researchers start with theoretical deductive reasoning and case study evidence, which identify structural weaknesses, organizational incentives, and regulatory holes as the causes of earnings manipulations. Lastly, the paper offers some recommendations on how to improve the governance framework for Indian start-ups.

2. Literature Review

- **Startup Company Corporate Governance**

  Research done on corporate governance is predominantly focused on large listed companies where wide investor plurality requires formal monitoring by which their board members are in principle held accountable for the decisions (Shleifer & Vishny, 1997;

OECD, 2015). However, start-ups define ownership more thinly; typically founders and venture capitalists are the major shareholders. Bhattacharya & Rani (2020) use an extreme example from an Indian perspective to go as far as to illustrate that corporate governance systems were dynamic and adapted quickly to changing business conditions in India, even if it meant compromising legality most of the time.

The corporate governance challenges for new ventures (i.e., controlling decision-making with founders forged by the presence of Hellmann & Puri, 2002) are also because they do not have external monitoring systems to act in the short-term profitability perspective of investors (Gompers & Lerner, 2004). For instance, as pointed out by Raghunathan (2021), board independence is the exception rather than the rule for early-stage businesses in India, and this has implications in terms of institutionalization of norms. governance

- **Earnings Management**

  According to Healy and Wahlen (1999), earnings management refers to the use of accounting discretion in order to distort financial performance. In this effort, techniques range from the manipulation of accruals (e.g., changing depreciation schedules) to the management of real activities in corporate operations (e.g., R&D cost delay). While some argue that it might be a proxy for future opportunity (Scott, 2015), the overwhelming research suggests that they would not (Dechow & Skinner, 2000).

  Some empirical studies in India, such as Mitra and Singh (2019), highlight the practice of earnings manipulation by privately held firms, including startups, during financing rounds. These consist of valuation pressure, funding tied to milestones, and competitive signalling.

- **Governance and Earnings Management in Start-ups**

  Numerous studies (Chen et al., 2011; Arundel, 2022) notice the tendency of small firms to improve their revenue utterance by poor corporate governance systems. Without an independent board or strong audit practices, with disclosure less rigorous than for mature companies, there are few barriers to distortion at start-ups. Examples of Indian startup debacles edtech unicorns inflating user counts and the like demonstrate how governance flaws can hurt both reputation and bottom lines.

3. Research Gap

However, despite much research done about corporate governance and earnings manipulation in listed companies, not as much research is present concerning economic misconduct relationships with start-ups in Indian ecosystem. Relevant literature is limited as either this study governance in developed firms or explore the strategies for growth of start-ups without considering integrity in financial reporting.

Specifically, gaps include:

- No empirical and conceptual studies have been conducted so far on governance mechanisms associated with earnings manipulation in Indian start-ups.

- Lack of understanding on the effect of how financing and investor expectations on earnings manipulation behavior.
- No deep dive into sector-specific risks such as in high-growth digital sectors

4. Objectives of the Study

- To assess the corporate governance issues in Indian start- ups.
- To understand the motivations and strategies for earning management in start-up through an analysis of earnings.
- This article has explored the relationship between corporate governance weaknesses and the risk of earnings manipulation.
- To proffer a governance framework suitable for Indian start-ups to reduce earnings management.

5. Research Methodology

This paper takes a conceptual-theoretical orientation, drawing upon the synthesis of secondary dataset from peer-reviewed journals references government reports and credible industry analysis (e.g. NASSCOM, SEBI, OECD).

- Research Design: development of Conceptual framework through literature synthesis.
- Data Sources: Academic databases (Scopus, JSTOR), regulatory guidelines (SEBI, MCA) and industry Case Studies.
- Focus: Indian startups in fintech, edtech, SaaS and e-commerce sectors.
- Analytical Method: Patterned subject review to determine Governance issues and relevant Earnings manipulation threats.

6. Data Analysis and Findings

Indian start-up history has been a fast ride of growth, and this growth has led to patterns in the way companies are governed, how they report numbers. A more thorough examination of secondary research, industry reports and real examples from the last several years highlights specific themes. The results from this section are divided into four groups: governance deficiencies, earnings management incentives, ordinary methods and sector-specific examples.

6.1 Governance Deficiencies in Start-ups

India is able to become one of the most dynamic entrepreneurial hubs in part by its speed, innovation, and appetite for taking risks. But below the surface of the story, overpowering it, is a simple fact: governance systems intended to safeguard stakeholders fail to keep pace with business growth. It can be distilled from industry studies, regulatory papers, and prominent case histories that four characteristics embed chronic infirmities that afflict many early- and growth-stage companies.

i. Concentration of Power in the Hands of Founders

Its founders hold high equity stakes in a lot of Indian start-ups, which guarantees them greater voting rights than their economic ownership. This makes the decisions faster, which is quite beneficial in the current market, as it is very competitive. But that also

means that all strategic decisions, particularly controversial trade-offs, are made by a tiny minority. As per the 2023 NASSCOM–PwC report, around 70% of high-value start-ups are founder-led with more than 40% share in voting rights. This kind of dominance can give rise to an internal climate in which rigorous accounting standards are easier to justify, serving as a bulwark against outside pressure.

ii. Minimal Independent Oversight

In the beginning, boards are often made up of founders and those few investors that have seats on the board. Public markets independent directors, non-holders and sellers of the valuations, at this stage are rare till the company comes close to public listing. By way of the 2022 SEBI update, before this point top-tier start-ups commonly have less than 10% independent representation. The lack of independent oversight limits the board's ability to question rosy revenue estimates or unorthodox accounting practices.

iii. Underdeveloped Internal Controls

Governance systems are the last thing early-stage start-ups worry about when they want to take over the world. No one is interested in setting up a strong internal audit team when companies are more focused on customer acquisition, product refinement & expansion. Should controls be in place, they are typically implemented to meet regulatory requirements rather than for risk management of operations or reporting. This lack of investment all but guarantees that mistakes or oversights will go unnoticed, leading to both accidental and deliberate misstatements.

iv. Pressure from Investors

Venture capital and private equity funding have a time horizon of five to seven years. Founders have implicit deadlines to hit revenue/user growth/profitability milestones tied to funding releases. This introduces an incentive for management to spin data in the most favourable manner. While these alterations may not always veer into full fraud territory, they do slowly legitimize behaviors that cloud the real financials.

6.2 Earnings Management Incentives

Start-ups are not the only place we see earnings management, but given the ecosphere they live in, it makes for a very tempting target. A number of those pressures are present in many start-ups' times, forcing them to massage their reported numbers.

i. **Funding rounds**

Access to capital is a highly competitive landscape, and valuations could change dramatically depending on the perceived growth of the company. This creates a strong perverse incentive in the month in advance of a funding round to push as much illegitimate revenue or users through the door as possible because if you can do that (even temporarily), it makes your business look like one worth investing in. That can involve recognizing revenue earlier than it generates sales or including free trials in subscription counts for investors.

ii. **Preparing for an IPO**

In a company going public, they are trying to represent stable, consistent growth. The best way to prepare in the quarters leading up to a filing is smoothing out earnings. IPOs are a legal manifestation of dirty backroom deals done before SEBI requires material disclosure and tender offers on behalf of shareholders.

iii. **Competitive positioning**

When too many new companies are getting in fights to compete for the same customers, these numbers start becoming a way to signal victory. Examples of these include overinflating GMV, active user numbers, or number of transactions, which naturally results in them appearing more robust than they are. This can be used to scare off rivals and help attract press attention, hires, and collaborations.

6.3 Common Techniques Observed

In start-ups, methods are combined into three groups to manage earnings-

i. **Accrual manipulation**

This means rephasing or rescheduling accounting entries without changing the underlying activity. E.g., in India this might be recognizing revenues from products not delivered yet, or deferring provision of expenses, or adjusting depreciation schedules to reduce current period costs. For example, there are SaaS companies that recognize the entire value of multi-year contracts as current revenue, which further exaggerates short-term performance.

ii. **Real activities management**

Such thinking is encouraged by what actually happens in the business: companies do things to avoid going bust or achieving various financial targets. In its submission to the committee, Jabo Nero cited a strategy from Indian start-ups such as deep discounting in the quarter or delaying some big spends, say on R&D, till after they have closed their books. While these moves make the short-term results more attractive to investors in that moment, they more often create problems down the road.

iii. **Inflating non-financial metrics**

Furthermore, with start-ups, profit is not the only measure; operational metrics come as a big focus for investors in most cases. This will result in overhyping daily active users, app downloads, or engagement rates. Dormant or duplicate accounts are sometimes counted as active users. In edtech and gaming, for example, there have been incidents in which engagement was reported only for the same users to drop off after receiving discounts or refunds.

6.4 Case Illustrations

While these patterns do not apply to all companies, they provide valuable examples of how these issues surface within the context of publicly reported incidents.

i. Edtech

Giving a clean chit to every big edtech in the country, no one has been found that is completely insulated from the fraud of inflating student enrolments and completion rates. Free trial users

were being considered as paid customers; refunds/course cancellations did not get reconciled with reported revenue.

ii. E-commerce

The workarounds applied by some e-commerce start-ups to inflate their GMV include selling in bulk to connected entities or prompting sellers to purchase their own products. These transactions are not illegal, but the display of cart volumes can hide some amount of real demand for markets.

iii. Fintech

Some startups in the lending vertical have recorded 100% of loans disbursed as revenue, leaving insufficient room for possible defaults. It makes profitability look greater in the short term but results in write-downs when an eventual default occurs.

6.5 Thematic Findings

Several patterns can be observed across these trends-

1. Governance maturity does not keep up with the growth of businesses Most start-ups only put governance structures in place when they are preparing to IPO, creating a hole that exists throughout the years when they grow most rapidly.
2. Image The relationship between founders and investors is key. With heavily investor orientated boards, there is a greater chance of this kind of financial reporting being challenged by shareholders. In markets where founders are dominant, monitoring is weaker.
3. Metrics are PR Points Given that valuations hinge upon growth signals, there's clearly a bias to present metrics in the most positive light possible, even if it means expanding definitions beyond recognition.
4. Private companies have fewer regulatory requirements. Since start-ups aren't required to disclose and audit their financials in the same way as a listed company, it allows for more room for fraud.

7. Summary and Conclusion

Though one of the most dynamic startup ecosystems in the world, continued rapid market expansion also opens up real vulnerabilities for India as a regional leader. Young companies, of course, are not in the same place as this fantasy; many still function with governance systems that are relatively informal and focus on the power of the founder (thanks to their old-school equity majority) and have been designed according to investor priorities. This suppresses the point of delay, which in turn makes earnings management a convenient, albeit risky, shortcut when it comes to meeting growth targets and securing funding.

The results confirm that the risk is more than theoretical. Weak internal controls, the lack of independent voices on boards, and the dominance of evaluation-driven goals all conspire to provide for conditions whereby both financial and perhaps especially non-financial metrics can be overstated. Such practices may lead a startup to short-term gains in terms of funding or

market perception, but they erode trust, distort decision-making, and can ruin your reputation once the truth is discovered.

The only sustainable manner in which the start-up sector will grow is the fact that governance models mature as the business scales. That requires integrating independent directors sooner, installing thoughtful internal audit systems, and adopting a culture of plain dealing long before any regulatory mandate. Founders bear some accountability, but this is not just a problem with entrepreneurs and investors; regulatory bodies also must contribute by increasingly setting the bar higher, less based on short-term optics as opposed to longer-term fitness. assert True stability.

Ultimately, avoiding earnings manipulation is not about stifling innovation. This is about growing companies on a bedrock of financial and ethical principles that will enable them to survive into the next few decades. Trust, integrity, and a firm commitment to reporting the news without fear or favour are not just boardroom values but business strengths in a world where credibility sustains market attention along with creativity.

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