CROSSING THE LINE

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When optimism becomes fraud

Following a boom year in 2021 where venture capital funding surged, global economic tailwinds and a notably higher interest rate environment have resulted in a marked downturn in deal-making activity. High-profile corporate failures, underpinned by allegations of fraud and misrepresentation, have also weighed on investor appetite for some early-stage ventures.

In April 2023, Charlie Javice, the founder of Frank, a U.S.-based startup focused on assisting students and their families applying for college financial aid, was arrested following accusations JP Morgan Chase was deliberately misled over customer data during the pre-investment due diligence process. In the same month Elizabeth Holmes, founder of Theranos, began an 11-year prison sentence. The trial of Sam Bankman-Fried concluded with his conviction in November 2023 for fraud following the collapse of FTX.

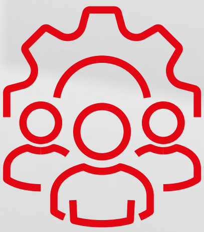
These are just a selection of cases that have made the headlines, where once highly-regarded entrepreneurs have had a spectacular downfall, along with their businesses. But there are thousands of other, less well-known examples of startups that have attracted investment because they showed such promise yet have turned out not to be the investments they seemed. In this article, we look at the ways in which startups can become hospitable environments for fraud, as a result of the conflation of a number of common attributes conducive to malpractice, namely weak corporate governance, counterproductive employee incentivisation plans, and growth or KPI targets which can encourage management to rationalise poor decision-making.

Corporate culture under scrutiny

Energy, optimism and innovation are all hallmarks of startups, and experienced investors know that most of these companies may never meet the growth projections in the timeline anticipated by their founders—many will even fail. Following the financial crash of 2008 and the resulting historically low interest rate environment, valuations nevertheless grew exponentially.

However, the rationale for the aggressive growth estimates underpinning these valuations is increasingly under scrutiny, not just for potential financial risk, but legal and reputational issues, should the company ultimately prove unable to defend its claims. It's one thing to be highly optimistic about the outlook for a new product. It's another matter to make representations that far exceed the company's capacity to deliver.

Investors have a vital role to play in governance by engaging in thorough due diligence of a target company and the management team prior to acquisition, followed by careful ongoing monitoring throughout the lifecycle of their investment. Not doing so carries the reputational risk of misrepresentation in company financials and shows a reluctance or an inability to test credibility of a business case. A lack of scrutiny could even lead to allegations of collusion, should misrepresentation later be uncovered.



Role of the founder and senior management team

The starting point for good governance is the founder and senior management team, who must set the tone for transparency.

A founder will naturally be protective of intellectual property (IP), but investors must consider carefully whether a management team is closely guarding certain key data out of concern for a genuine commercial threat, or because all or part of the fundamentals that the team is relying on for product specification or revenue growth are not in place—and not even close.

Steve Jobs may have famously said: "The people who are crazy enough to think they can change the world are the ones who do." But buying into an entrepreneur's vision should not preclude hard questions around the status of key elements of the technology or business plan, and a strong management team will engage in discussions around their best, average and worst-case growth scenarios. Is the company already working with or open to the idea of having a third-party valuation advisor cross-check its assumptions? How might the company's estimates compare to industry norms? Is the company relying on the "novelty" of the business concept to justify a lack of disclosure? If the company operates in an emerging or frontier economy, is there an attempt to pass off unusual operational activity, expenses or advisor relationships as just "how things are done here"?

Most importantly: Is the founder surrounded by a hand-picked team of supporters unwilling or unable to challenge them?

Many of the recent high-profile startup collapses capitalised on the idea that the complexity of the product offering was one of the "magic ingredients" underpinning a high valuation that justified resistance to external scrutiny. But an investible product or service does not rely on confusion, obfuscation or the requirement to be an "insider" to understand its value. In fact, this is a significant red flag; think the Emperor's New Clothes and ask the obvious question.

Accounting controls and compliance

In startups and early-stage companies, the finance function is often immature and frequently lags behind the company's growth, in terms of capability and capacity. Founders tend to be focused on their vision and less worried about the "numbers". Furthermore, the characteristics that make entrepreneurs a success, such as strong and dominant personalities, can misfire if directed to encourage a finance function to "make the numbers work". The absence of a compliance function or framework in early-stage startups further adds to an environment conducive to fraud, should the opportunity and motivation arise. It is no coincidence that in nearly every portfolio company fraud investigated by Kroll, the wrongdoing has been the result of an aggressive CEO founder, who has taken advantage of such a scenario.

The Fraud Triangle can be overused, but the concept is applicable in relation to the risks associated with financials in startups:

- **Opportunity:** Typically, a small function, with limited checks and balances, often very loyal to the founder and unlikely to question their directives
- **Motivation:** Wanting to make the numbers work to prove their thesis or meet aggressive incentivisation plans
- **Rationalisation:** It's my company so my money, and this is only short term while we get through a "blip"

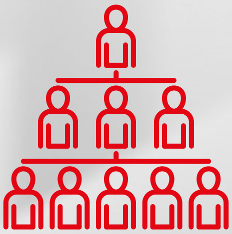
All too often we see a lack of detailed, financial due diligence at an early investment stage, both pre- and post-capital raise, with too much reliance placed on investor presentations and audited financial statements. Even at later stage funding rounds, there tends to be a focus more on testing the financials from a growth and valuation perspective, as opposed to stepping back and testing the veracity of key accounting line items.

Founders should be focused on ensuring that the accounting and financial reporting system they are building, if it is not already fully in place, is sufficiently robust to withstand external scrutiny from third parties seeking to evaluate the credibility of their financial projections and that there is evidence of separation of duties, oversight and documentation of financial processes.

Approach to legal and regulatory risk

A similar temptation to cut corners may be present in legal or regulatory functions when a company is under pressure to chase growth.

It can be argued that, by definition, a disruptive technology or service will push existing legal and regulatory boundaries. But such a business requires sophisticated support to demonstrate that challenges to the “status quo” meet legitimate commercial needs and have not arisen out of ignorance of, or wilful disregard for, applicable laws and regulations in order meet short-term valuation objectives.



A sound incentivisation structure

Setting realistic expectations around product development milestones and revenue growth is key to addressing the temptation a management team may feel to cut corners in order to meet investor KPIs, especially when their personal compensation is closely linked to these goals or required to secure a new round of fundraising.

Where there is a lack of transparency and good communication between the management team and investors, fear can spread that the whole venture could collapse following a period of softer revenue, customer numbers or a setback on the research and development front. This could form the basis of a decision to present performance metrics which evade the truth.

The right sort of optimism

“Fake it till you make it” has become a well-known motto associated with the startup industry. Certainly, such an outlook can provide just the excuse for a management team to rationalise poor decision-making or outright misrepresentation, in an environment in which achieving “unicorn” status—a USD $1 billion valuation—has been viewed as the ultimate goal.

However, the value a thoughtful and engaged investor can bring to a startup through the application of consistent oversight and governance advice cannot be underestimated. This is particularly valid in sectors, including many fields of nascent technology, where formal regulation may not be keeping pace with the scale of entrepreneurial activity, perhaps due to a lack of government investment in supervisory bodies.

The payoff of investment in strong governance structures is not just the avoidance of financial risk or civil and criminal liability, but higher exit valuations and the sort of reputational profile for both the company and its backers that requires no reliance on “faking it.”