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gundeep kaur

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# THE INFLUENCE OF BOARD CHARACTERISTICS ON CORPORATE ILLEGALITY

## ABSTRACT

**Purpose:** In light of frequent corporate scams and frauds, this paper investigates the relationship of corporate illegality with the board of directors' characteristics in Indian manufacturing companies.

**Design/methodology/approach:** The board of director characteristics of sample companies charged with violation of the Securities Exchange Board of India (SEBI) regulations from 2008 to 2013 are matched to an equivalent-sized control dataset. A cross-sectional logistic regression model is applied to test the hypothesized association.

**Findings:** The findings suggest that the SEBI violations are less likely to occur when a large fraction of the board of directors consists of independent directors and when the individual directors have multiple appointments on the boards of other companies. However, it is observed that the size of the board and its meetings have no observable association with violation of the SEBI regulations.

**Research limitations/implications**: This work is likely to aid future research in exploring the impact of governance mechanisms on the occurrence of illegality. In future, studies may be conducted to investigate the probability of illegal corporate events using a larger sample size and corporate governance variables which have not been examined in the present study.

**Practical/Policy Implications:** The analysis provides corporate policy makers and investors an insight to evaluate the vulnerability of a company being engaged in illegality based on its' board features.

**Originality/Value:** The present study is distinct from previous reports as it makes a novel attempt to gauge the relationship between the board of directors' characteristics and the occurrence of illegality in the Indian corporate section.

**Keywords:** Corporate Governance, Corporate Illegality, Board Independence, Independent Directors, SEBI Regulations, Logistic Regression.

**Paper Type:** Research paper

## 1. INTRODUCTION

Fraudulent activities, ethical breaches and performance lapses in companies like WorldCom, Enron, Adelphia Communications Corp., Lehman Brothers, Tyco Ltd., and the like have given a severe blow to the integrity of corporate governance systems (Hwang and Blair Staley, 2005; Hope and Player, 2012). In the Indian capital market as well, a series of corporate frauds, business scams, and white collar crimes have drawn the attention of the investors worldwide. Incidents like the Ketan Parekh scam (2001), Home Trade scam (2002), Satyam Computers scam (2009), Sahara Housing Bonds scam (2010), Speak Asia scam (2011), Saradha Chit Fund scam (2013) are glaring examples of regulatory loopholes. They raise serious concern about the corporate governance practices and credibility of financial reporting in Indian companies.

An effective governance framework is an essential tool for achieving a high level of performance in the firm. The agency theory asserts that the opportunistic behavior of the directors and managers must be curbed to maximize shareholders' value (Fama and Jensen, 1983). For this reason, immense importance is given to board composition and leadership, since it is the directors who strategize and take chief decisions regarding the functioning of a company. The board is also held responsible for monitoring, managing and evaluating the operations of the

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company and its top executives to ensure effective progression. This requires the board to comply diligently with the regulations established by the statutory bodies (Baysinger and Butler, 1985). Non-conformity with laws gives way to corporate illegality, thereby leading to loss of stakeholders' confidence in the company.

Pressures from the external environment, motivation to engage in wrongdoing, availability of opportunity, and the exercise of choice by management to exploit such opportunities are the key factors leading to corporate illegality. Dunn (2004) suggests that corporate illegality is an outcome of the decisions taken by the managers. According to Baucus (1994), corporate activities, intentional or unintentional, explicitly declared by laws to be unethical, unacceptable and impermissible fall in the class of corporate illegality. It encompasses both corporate crime and illegal corporate behavior. Corporate crime consists of actions that violate criminal laws. On the other hand, violation of civil and administrative laws entailing fines, attachment of property, consent decrees and judgments by government agencies against the firm, falls in the domain of illegal corporate behavior. Such events can be accredited to the weak governance structure of the company and delegation of much board power in the hands of inside directors which have connections with the company. The outsider dominance perspective advocates that a higher proportion of independent directors on the board disconnects it from the insider relations. At the same time, it strengthens the board's scope of power and extent of knowledge.

The Securities Exchange Board of India (SEBI) is a statutory body acting as a supervisor, regulator, and controller for securities market in India. Significant corporate governance reforms relating to board structure and composition, ownership structures and audit committee

functioning have been introduced in the Indian corporate sector through its policies, recommendations, and amendments in the Clause 49 of the Listing Agreement.

This empirical study is based on the contraventions of the SEBI regulations by Indian manufacturing companies from the financial year 2008 to 2013. For the purpose of this study, corporate illegality includes any act of violating the SEBI Act of 1992 and other statutory regulations prescribed by the SEBI for companies listed and trading in stock markets. The sample comprises of thirty companies from the manufacturing industry that violated the SEBI regulations during the study period and were matched to thirty control companies with no violations. The primary objective of this paper is to test the relationship of corporate illegality and board characteristics that has been previously established in Australia (Sharma, 2004), Canada (Park and Shin, 2004), China (Chen *et al.*, 2006), Malaysia (Abdullah, 2006; Salleh and Othman, 2016; Shan *et al.*, 2013), and the United States (Beasley, 1996; Dunn, 2004; Kesner *et al.*, 1986; McKendall and Wagner III, 1997; McKendall *et al.*, 1999; Uzun *et al.*, 2006). The research will contribute to the existing literature since this association has not yet been extensively explored in the Indian context. Thus, this paper is a leap towards establishing the relationship between corporate governance characteristics and corporate illegality in the Indian background. The results posited by the study will draw the attention of policy makers towards focal points of board composition which may act as a check on illegality. Further, the stakeholders can appraise companies based on their board characteristics and researchers, in future, can investigate critical governance aspects contributing to corporate wrongdoing.

The forthcoming section of this paper deals with the review of relevant literature and hypotheses development, followed by section three which describes the research methodology.

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The fourth section states the empirical results and section five presents the summary and discussion on the prospects for research.

## 2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

The effectiveness of governance practices in any organization can be best described in terms of the various corporate governance theories rather than basing it on a single trail. The fundamental theory of corporate governance i.e., the agency theory and the resource dependency theory can be used to examine the research hypotheses for the current study. In circumstances where a company may be involved in violation of statutory regulations, the agency theory comes into play by rationalizing the role of an independent board. Multiple directorships and board size variations can be analyzed using the resource dependency theory. The theory supports the notion that directors holding position on various boards act as an asset for the company due to their ability to attract desirable resources, gather critical information and network in a way that benefits the organization. The review of the literature concerning the said corporate governance theories shapes the hypotheses presented ahead.

### 2.1 Board Independence

The board of directors comprising of outside and inside directors, are expected to ensure that the company complies with the regulatory framework (Cary & Eisenberg, 1980). The inside directors hold a position where they can provide important information about corporate operations. They also have an incentive to hide sensitive information relating to the poor performance of the company and abrasiveness in conformity with statutory laws to secure their jobs at the expense of shareholder interests. Williamson (1984) noted that the board of directors

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might become an instrument for the management given that they have full access to company's confidential information.

Outside directors, on the other hand, are believed to represent the interests of the shareholders in a better manner as their reputation cost is attached to the revelation of corporate fraud and litigation (Bhagat *et al.*, 1987). Prior research has documented an association between board independence and higher quality of reported earnings (Dechow *et al.*, 1996; Vafeas, 2005). Fama (1980) and Fama and Jensen (1983) suggest that there is an effective check on the management activities when a majority of outside directors are present on the board. Beasley (1996) and Sharma (2004) established that fraud companies have a higher proportion of insider directors on their respective boards in contrast to no-fraud companies, whose boards' are dominated by outside directors. Park and Shin (2004) and Peasnell *et al.* (2005) found that only outside directors having financial expertise can control earnings management. An inclination towards greater representation of independent directors on the board revolves around the proposition of agency theory that supports separation of ownership and control (Jackling and Johl, 2009), and advocates that boards separated from management are better positioned to monitor executives by curbing their opportunistic behavior. Kim *et al.* (2013) observed that activities involving corrosion of financial statement quality and violation of securities laws have a greater probability of being detected by the outside directors. In context of the above literature, the following hypothesis is proposed:

*Hypothesis 1: A high proportion of independent directors on the board are negatively associated with corporate illegality.*

*2.2 Board Size*

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Fraud and failures in big business houses may have some relationship with the size of the corporate boards. The resource dependency theory asserts that a company can improve its governance and performance through directors who are equipped with valuable resources and profound networking in the external environment (Nicholson and Kiel, 2007). Forbes and Milliken (1999) gave evidence that larger board size can diminish the dominance of CEO. In contrast, Bacon (1993) and Yermack (1996) substantiated that the effectiveness of a small board is greater than that of large boards. The same was supported by Jensen (1993) who claimed that the probability of a board functioning effectively declines when it has more than seven or eight members. Beasley (1996) and Dechow *et al.* (1996) gave evidence that fraud companies tend to have a larger board as compared to no-fraud companies. Abdullah (2006) showed that financially distressed companies in Malaysia have a large board size. This notion that board size and corporate illegality may be causally related suggests the following hypothesis:

*Hypothesis 2: A large board size is positively associated with corporate illegality.*

### 2.3 Board Meetings

There are contradictory reports in the literature regarding the association of company board meetings and the extent to which they help in checking illegality. In the view of Byrne (1996) and Lipton and Lorsch (1992), a board that meets frequently indicates the assiduous performance of its duties. While examining the information asymmetries in the firm and industry that affect fraudulent reporting, Ndofor *et al.* (2013) empirically illustrated a negative relation of board meetings with the probability of financial restatements and company's stock market performance. Salleh and Othman's (2016) logistic model also demonstrated that board meetings

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can be an effective tool to monitor company activities and deter the occurrence of fraud in Malaysian companies.

Conversely, Vafeas (1999) suggested that increase in the number of board meetings is an indicator of company's poor performance. Analyzing the enforcement actions of the Chinese Securities Regulatory Commission, Chen *et al.* (2005) stated that increased board meetings symbolize the existence and responsiveness of company's questionable behavior by the board of directors. Inspection of Malaysian companies by Shan *et al.* (2013) reiterated a similar relationship. Based on literature the following hypothesis is formulated:

*Hypothesis 3: Greater number of board meetings is positively associated to corporate illegality.*

### 2.4 Board Busyness

"Busyness hypothesis" as stated by Ferris *et al.* (2003) can be expressed in terms of the number of directorial positions an individual director occupies on the boards of other companies. In India, the busyness of directors may be attributed to the paucity of adequate experience and industrial leadership in the managerial strata. Fich and Shivdasani (2004), Lipton and Lorsch (1992), Morck *et al.* (1988) and Shivdasani and Yermack (1999) noted that directors incumbent on multiple boards devote lesser time in effective supervision of management, which has detrimental effects on the shareholder and firm value and may result in earnings management. Schnake et al. (2005) found that companies are more likely to engage in illegality when they are not monitored effectively. Beasley (1996) affirmed that the probability of financial statement fraud is elevated if the independent directors on the board are over committed. In the light of these arguments, the following hypothesis is proposed:

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*Hypothesis 4: Multiple appointments of directors on the board of other companies are positively associated to corporate illegality.*

Thus, a comprehensive survey of the previous studies confirms that board attributes certainly influence company's illicit activities. While various studies have investigated the relationship of board of directors and performance of companies of Indian origin (Black and Khanna, 2007; Dey and Chauhan, 2009; Dwivedi and Jain, 2005; Garg, 2007; Ghosh, 2006; Jackling and Johl, 2009; Patibandla, 2006; Sarkar and Sarkar, 2009), no substantial research has explored its association with corporate illegality. The results presented in this article have addressed this gap in the literature.

## 3. RESEARCH METHODOLOGY

### 3.1 Sample Selection and Data Sources

The population of the study consists of 1,226 companies alleged of illegality in the years from 2008 to 2013. These companies had *prima facie* violated the statutory provisions of the SEBI (provided in **Table 1**). The SEBI violations were adopted from www.watchoutinvestors.com web server. The SEBI has levied charges and taken regulatory actions against these companies for the same. Consistent with previous studies of Chen *et al.* (2006), Shan *et al.* (2013) and Sharma (2004) the sample companies with name changes were removed to avoid duplication of data points. The sample companies outside the study period and indirectly involved in illegality were eliminated.

Insert Table 1 about here

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To approach the final test sample, private companies, co-operative companies and trusts were deleted from the sample. Then, companies which were unlisted and suspended from trading on the Bombay Stock Exchange (BSE) during the study period were excluded. Next, companies which did not satisfy the control sample selection procedure were removed followed by companies for which adequate data was unavailable. Lastly, a company defunct with respect to its board composition was removed. Mc Kendall *et al.* (1999) have studied the effect of board composition characteristics and the event of environmental violations for companies in manufacturing industry. Following prior research methodology, all the companies from non-manufacturing industry were also excluded and only manufacturing companies constituted the final sample. The exclusions have been tabulated in **Table 2**.

Insert Table 2 about here

The final sample used to test the hypotheses consists of 60 listed companies of which thirty companies represent the sample companies with illegality and the other thirty companies form the control sample with no illegality. The data for independent and control variables was collected from the Prowess database of the Centre for Monitoring Indian Economy (CMIE), the annual reports and the corporate governance reports of respective companies.

### 3.2 Control Company Selection

Many studies on corporate financial misconduct have used matched pair designs (Abdullah, 2006; Agarwal and Chadha, 2005; Beasley, 1996; Chen *et al.*, 2006; Dunn, 2004; Hsu and Wu, 2014; Ndofor, 2013; Salleh and Othman, 2016; Summers and Sweeney, 1998; Uzun *et al.*, 2004). The control companies were identified that were akin to the sample companies in

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terms of size, industry, stock exchange and time period. The matching criteria have been adopted from Beasley (1996) and explained in **Table 3**.

Insert Table 3 about here

Since the data assumed a non-parametric distribution, the Wilcoxon Signed Ranks test was conducted to compare the sample companies with the control companies. **Table 4** highlighting the differences in the median values for the two groups shows that they are not statistically different from each other with respect to profit after tax ($Z$ = -0.442, $p$ = 0.658) and total assets ($Z$ = -0.072, $p$ = 0.943). Thus, the two sample sets can be studied in a comparable manner.

Insert Table 4 about here

### 3.3 Variable Selection and Description

The features relating to the board of directors are examined to explore the illegal behavior of sample companies. A set of independent variables related to the board characteristics and control variables associated with company's profile are used to test the dependent variable. The independent variables are measured in the year ($t$ - 1) prior to the year in which illegality was first reported (Beasley, 1996; Chen *et al.*, 2006; Ndofor *et al.*, 2013).

**3.3.1 Dependent Variable: ILLEGALITY** is the dependent binary variable with an assigned value equal to 1 when the companies have committed illegality and 0 otherwise i.e., coded 1 for sample companies and 0 for control companies (Abbott *et al.*, 2002; Beasley, 1996; Chen *et al.*, 2006; Dunn, 2004; Mc Kendall *et al.*, 1996; Ndofor *et al.*, 2013; Salleh and Othman,

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2016; Summers and Sweeney, 1998). It indicates the occurrence of SEBI violation i.e., an illegal event for the first instance in the sample companies.

*3.3.2 Independent Variables: OUT_DIR* **(%)** is the key variable of the study indicating the representation of independent directors on the board of the company (Beasley, 1996; Chen *et al*., 2006; Jackling and Johl, 2009; Ndofor *et al.*, 2013; Shan *et al.*, 2013). In the present study, it represents the percentage of independent non-executive directors on the board of the company. Clause 49 of the Listing Agreement states that an 'independent director' is one who does not have any pecuniary relationship with the company besides receiving remuneration. A negative and significant coefficient on the variable, in the logit model, would support *H1* i.e., the proportion of independent directors is lower for illegality companies in contrast to the no-illegality companies.

*BRD_SIZE* signifies the total number of directors on the board of a company (Chen *et al*., 2006; Jackling and Johl, 2009; Salleh and Othman, 2016; Shan *et al*., 2013; Uzun *et al*., 2006). A positive and significant coefficient will admit *H2* and suggest that with the increase in the number of directors on the board, the chances of illegality will also increase.

Consistent with Chen *et al*. (2006), Jackling and Johl (2009), Ndofor *et al.* (2013), Shan *et al*. (2013), and Uzun *et al*. (2006), *BRD_MEET* symbolizes the total number of board meetings held annually. Clause 49 of the Listing Agreement stipulates a minimum of four board meetings per year, with a maximum interval of four months between any two subsequent meetings. *H3* is supported if its' coefficient is positive and significant.

The average number of director positions held by an individual director on the board of companies other than the sample company in the year of illegality is represented by the variable *BRD_BUSY* (Jackling and Johl, 2009). Section 165 of the Companies Act of 1956 stipulates that

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the maximum number of directorships a person can hold is 20. In case the company is a holding or a subsidiary company of a public company, the number of directorships shall be limited to 10. A significant positive association is predicted between the busyness of director and occurrence of illegality to support *H4*.

*3.3.3 Control Variables:* Rapid growth is expected to be associated with the incidence of fraud (Beasley, 1996; Bell *et al.*, 1991). A percentage change in the total assets of the company two years prior to the year of illegality is taken as the value of ***GROWTH*** (Beasley, 1996). Environmental uncertainty pertaining to the structure of the company and its sustained growth may stimulate fraudulent practices in the organization (Baucus and Near, 1991; Pugh *et al.*, 1968). In order to maintain the company's reputation, managers may resort to illegal corporate practices when growth is slow or reverses its trend. Loebbecke *et al.* (1989) found that twenty-nine percent companies in their fraud sample had reported a high growth rate. Thus, a positive relationship is anticipated between company growth and illegality.

***AGE*** is the difference between the company's year of listing on the BSE and the year of alleged illegality (Beasley, 1996; Shan *et al.*, 2013). According to Abbott *et al.* (2002), a firm trading for a longer period in public markets is more likely to comply with the rules and requirements and thus have a lower likelihood of financial misstatements. Thus, newly listed public companies are considered to have a greater risk of committing fraud to meet the earning expectations. A negative association is expected between illegality and age.

### 3.4 Multivariate Tests

The research design is similar to that used in Beasley (1996). A cross-sectional logistic (logit) regression model is used to test the hypotheses. Since the dependent variable, illegality, is

dichotomous and illegal activities are infrequent events, use of matched-pair sample design is most suitable (O'Conner *et al.*, 2006; Stone and Rasp, 1991). The proposed logit model intends to examine if corporate governance variables are substantial factors contributing to illegality and not to predict the occurrence of illegal events. The logit regression model is as follows:

$$ILLEGALITY = \alpha + \beta_1 OUT\_DIR_i + \beta_2 BRD\_SIZE_i + \beta_3 BRD\_MEET_i + \beta_4 BRD\_BUSY_i + \beta_5 GROWTH_i + \beta_6 AGE_i + \varepsilon_i$$

where,

| | |
|---|---|
| i | Companies 1 through 60. |
| ILLEGALITY | Dependent binary variable with the value of 1 for sample companies and 0 for control companies. |
| OUT_DIR | The percentage of independent non-executive directors on the board. |
| BRD_SIZE | The total number of directors on the board. |
| BRD_MEET | The number of annual board meetings. |
| BRD_BUSY | An average number of directorships held by a single director on the board of other companies. |
| GROWTH | Percentage change in total assets two years preceding the year of illegality. |
| AGE | The number of years the company's stock has traded on a Bombay Stock Exchange until the year of illegality. |
| ε | The residual |

### *3.5 Descriptive Statistics and Correlations*

A comparison of sample and control companies is shown in **Table 5**. The descriptive statistics are reported in **Panel A** of **Table 5**. The statistics show that on an average there are 7 directors on the board of directors *(BRD_SIZE)* of all companies, of which 53.43 percent are outside directors *(OUT_DIR)*, thus satisfying the requirement of Clause 49 of the Listing agreement to have at least 50 percent independent non-executive directors on the board when the chairman is an inside director. The frequency of board meetings *(BRD_MEET)* varies from 3 to 19, with an

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average of 8 meetings annually. The results also suggest that the mean directorships *(BRD_BUSY)* held by a director on the board of other companies are about 3. The control variable **GROWTH** has a mean value of 23.06 million and the average **AGE** is 16.45 years.

Comparing the sample and control companies shows that the mean for **OUT_DIR** is 48.37 and 58.50, respectively, which demonstrates a higher degree of board independence in control companies. The average **BRD_SIZE** for sample and control group is 6.83 and 7.33, respectively. The number of **BRD_MEET** conducted annually is marginally higher in sample companies as compared to control companies, i.e., 7.83 and 7.30, respectively. The variable **BRD_BUSY** in sample and control companies is 2.37 and 2.83, respectively. **Panel B** of **Table 5** presents the results for Wilcoxon Signed Rank Test demonstrating no statistical difference in the medians of sample and control companies.

Insert Table 5 about here

The current study uses Spearman's Rank Correlation (rho) to identify the degree of association between the variables assuming a non-parametric distribution. The results in **Table 6** show that **OUT_DIR** has a significant ($p < 0.01$) negative correlation with illegality. This provides support for *H1* asserting a low level of illegality with greater independence of the board. It is also seen that **GROWTH** is positively correlated ($p < 0.01$) to **AGE**. Correlation results demonstrate that illegality does not have a significant relationship with independent variables, *viz.* **BRD_SIZE**, **BRD_MEET**, **BRD_BUSY**, and control variables, *viz.* **GROWTH** and **AGE**.

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To test for multicollinearity, the variance inflation factor (VIF) was calculated. All the VIF values (reported in **Table 6**) were far below 10, indicative of the fact that no multicollinearity exists among the independent variables.

Insert Table 6 about here

## 4. RESULTS AND ANALYSIS

### *4.1 Multivariate Logistic Regression Results*

The results of logit model are chalked out in **Table 7**. The model is well specified ($p < 0.05$) and has a pseudo $R^2$ of 23.2 percent (Cox & Snell R Square) and 31.0 percent (Nagelkerke R Square) indicating a noteworthy improvement over the base model. The Hosmer and Lemeshow test for goodness-of-fit shows that the $\chi^2 (8) = 4.176$ ($p > 0.10$) signifying that the model predicts values that are significantly different from the observed values i.e., the model is well fitted. The predicted success rate of the model is 74.6 percent. **Figure 1** shows the area under the Receiver Operating Characteristic (ROC) curve is 0.806 ($p < 0.01$), signifying that the logistic regression model correctly classifies the groups and the test results are sufficiently accurate. Thus, this model can be considered adequately reliable.

**Table 7** shows that the coefficient for ***OUT_DIR (%)*** is both negative and statistically significant ($\beta = -1.136$, $p < 0.05$) indicating that an increase in the ratio of independent directors will decrease the likelihood of illegal events for this sample. Though contradictory to the findings of Kesner *et al.* (1986) and McKendall *et al.* (1999), the results support the agency theory and are in accord with Beasley (1996), Chen *et al.* (2005), Dunn (2004), Fama and Jensen (1983), and Uzun *et al.* (2004). It can be understood that reputational costs associated with the filing of legal suits on the company, for illegallity, acts as a driver for the outside directors to

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thwart questionable events (Bhagat *et al.*, 1987) and prevent the release of fraudulent financial information (Dunn, 2004). The results demonstrate that the percentage of outside directors is lower for companies engaged in illegality than the control firms i.e., *HI* is supported. Thus, it is evident that non-executive directors have greater incentives to monitor management activities (Abdullah, 2006) and their representation in majority improves the performance of the firm (Jackling and Johl, 2009).

The results for ***BRD_SIZE*** are in compliance with corresponding results in studies conducted by Abdullah (2006), Beasley (1996) and Dechow *et al.* (1996) though the coefficient is not statistically significant ($\beta$ = -0.318*, p > 0.05*). Similarly, ***BRD_MEET*** poses a positive relationship as predicted but the non-significant coefficient ($\beta$ = 0.327*, p > 0.05*) does not fully uphold the findings of Chen *et al.* (2005), Shan *et al.* (2013) and Vafeas (1999). Therefore, *H2* and *H3* are rejected.

As opposed to the predicted positive relationship between the busyness of directors and corporate illegality, the coefficient for the multiple directorships (***BRD_BUSY***) is negatively significant ($\beta$ = -0.579*, p < 0.10*). Thus, it does not support the hypothesized relationship between increased corporate illegality and multiple directorships of the directors. The findings, however, affirm the resource dependency theory and results of Brown and Maloney (1999), Ferris *et al.* (2003) and Miwa and Ramseyer (2000) that multiple appointments of directors and their networking in the external environment generates benefits for the firm, thereby leading to an improvement in the firm's performance. The paucity of qualified directors in the Indian executive market justifies the results. Mohanty and Mitra (2016) state that Indian companies that do not appoint independent directors more than the statutory requirements have greater

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profitability than their counterparts hiring over statutory conditions. Thus, the results for the sample are consistent only with *H1*.

The coefficient for the control variable ***GROWTH*** is not significant ($p > 0.10$) showing that the likelihood of illegality does not increase with company's growth. ***AGE*** shows a statistically significant coefficient ($p < 0.10$). It can be assumed that owing to the stakeholder's expectations to maintain market share and reputation, the directors in old companies violate the statutory regulations and sustain its image.

## 5. SUMMARY AND CONCLUSIONS

The economic and financial crisis in diverse high profile companies has led to the breakdown of public faith in the governance practices. A simultaneous effort has been made by the regulatory agencies to uplift the standard of mandatory and non-mandatory governance practices in Indian companies through reforms in Clause 49 of the SEBI's Listing Agreement and amendments in the Companies Act of 1956. The object of this study was to identify the relationship of illegal corporate acts with board characteristics in the Indian manufacturing companies. The results show that corporate illegality can be checked if the power is in the hands of independent directors. This sample supports the resource dependency theory advocating that multiple appointments of directors lends a resourceful hand to companies in emerging economies like India. The model favoring greater representation of outside directors and multiple directorships gives evidence that the effectiveness of the board corresponds to the external environment. However, the hypothesized relationship with board size and board meetings was not supported.

There are a few limitations to this study. First, the number of sample companies studied is small as the control company selection procedure could not be successfully applied to the

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complete sample and adequate data was unavailable for the sample companies. This hampers the ability of results to be generalized. Secondly, only the Indian manufacturing industry was examined with a restricted number of variables related to corporate governance. Despite the limitations, it is deemed likely that this study will contribute immensely by reducing the literature gap on the examination of illegal corporate events in the Indian set up. Future research could be directed to study other aspects of corporate governance affecting corporate illegality. Exploring the events of illegality in industries other than the manufacturing industry is another promising area for future research. Further, researchers could explore the influence of ownership structures on the propensity to commit and deter illegal activities. This study has practical implications for managers and policy makers who are headed towards diminishing the agency problem by the inclusion of a greater proportion of non-executive directors on the board.

It can be summarized that the corporate governance features affecting the unethical and illegal practices in Indian corporate sector have been addressed by the SEBI through the enactment of its policies, regulations, and laws. However, in a developing nation like India, there is an urgent need for stringent application of laws that can check the progression of wrongdoings that have corporate as well as societal ramifications.

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**Figure 1**

**Area under ROC Curve**



| N | Area under the Curve | $p$ - value |
|---|---|---|
| 60 | 0.806 | 0.000 |
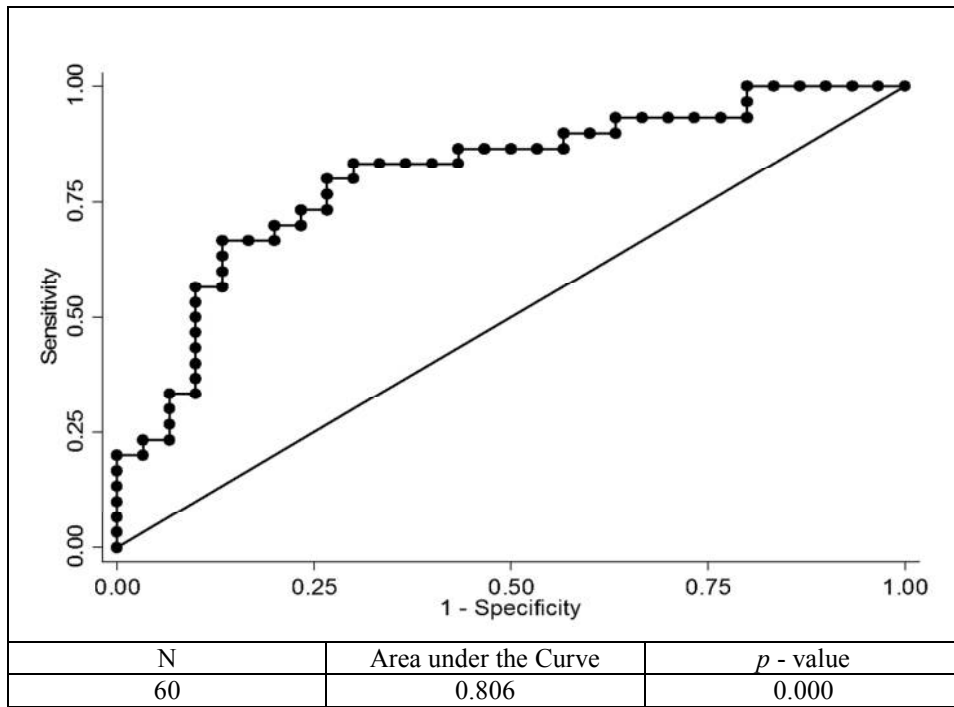
**TABLE 1**

**The SEBI Violations - Population and Sample Companies**

| VIOLATION | No. of Companies in the POPULATION | No. of Companies in the SAMPLE |
|---|---|---|
| ACTED AS SUB-BROKER WITHOUT SEBI REGISTRATION | 2 | - |
| ADOPTED IMPROPER ACCOUNTING PRACTICES | 1 | - |
| ALLOWED WRONG UTILIZATI ON OF ISSUE PROCEEDS | 6 | - |
| COMMITTED IRREGULARITIES IN MAINTENANCE OF CLIENT REGISTRATION/DATABASE | 1 | - |
| COMMITTED IRREGULARITIES IN CONTRACT NOTES | 2 | - |
| DEALT AND INTRODUCED TAINTED/ STOLEN/ FABRICATED/ DUPLICATE SHARES | 1 | - |
| DEALT WITH UN-REGISTERED BROKERS/SUB-BROKERS/ENTITIES | 1 | - |
| DEFAULTED/IRREGULARITIES IN PAY-IN OBLIGATIONS | 2 | - |
| DELAYED/FAILED TO APPOINT COMMON SHARE REGISTRAR FOR HANDLING SHARE REGISTRY WORK OF DEMAT AND PHYSICAL SECURITIES | 1 | 1 |
| DELAYED/FAILED TO DELIVER/TRANSFER SECURITIES | 3 | - |
| DELAYED/FAILED TO MAKE PAYMENT TO CLIENTS | 2 | - |
| DID NOT EXERCISE DUE SKILL AND DILIGENCE | 3 | - |

1

| | | |
|---|---|---|
| DID NOT PAY PENALTY | 33 | - |
| DID NOT PAY PENALTY AMOUNT IMPOSED BY SEBI | 1 | - |
| DID NOT REDRESS INVESTOR/CREDITORS COMPLAINTS | 51 | 2 |
| FAILED TO MAINTAIN PROPER BOOKS OF ACCOUNTS/RECORDS | 2 | - |
| FILED APPLICATION FOR SEEKING EXEMPTION FROM MAKING PUBLIC ANNOUNCEMENT | 2 | - |
| INDUCED INVESTORS THROUGH FALSE/ MISLEADING REPRESENTATION | 222 | 2 |
| MANIPULATED MARKET AND/OR INDULGED IN UNFAIR TRADE PRACTICES | 202 | 2 |
| INDULGED IN CANCELLATION OF GDRS FOR CONVERTING THEM INTO NORMAL SHARES TO SELL IN INDIAN MARKET | 14 | - |
| INTRODUCED UNLISTED SHARES IN THE MARKET | 8 | - |
| MANIPULATED IPOS OF VARIOUS COMPANIES | 1 | - |
| MISUSED/DEFAULTED IN MAINTAINING CLIENT ACCOUNTS | 1 | - |
| NOT A FIT AND PROPER PERSON | 2 | - |
| ORDER UNDER SECTION 11B READ WITH 11 OF SEBI ACT, 1992 | 1 | - |
| PROVIDED MANIPULATED BOOKS OF ACCOUNTS/ RECORDS TO INCOME TAX DEPARTMENT | 1 | - |
| PROVIDED WRONG INFORMATION IN OFFER DOCUMENT | 3 | - |
| PROVIDED WRONG/INCOMPLETE INFORMATION TO | 1 | - |

2

| EXCHANGES | | |
|---|---|---|
| VIOLATED CODE OF CONDUCT | 2 | - |
| VIOLATED COMPANIES ACT, 1956 | 3 | - |
| VIOLATED SEBI (DEPOSITORIES AND PARTICIPANTS) REGULATIONS, 1996 | 11 | 2 |
| VIOLATED SEBI (DISCLOSURE AND INVESTOR PROTECTION AND SECURITIES CONTRACTS (REGULATIONS) RULES, 1957 | 1 | - |
| VIOLATED SEBI (DISCLOSURE AND INVESTOR PROTECTION) GUIDELINES, 2000 | 12 | 2 |
| VIOLATED SEBI (FOREIGN INSTITUTIONAL INVESTORS) REGULATIONS 1995 | 1 | - |
| VIOLATED SEBI (ISSUE OF CAPITAL AND DISCLOSURE REQUIREMENTS) REGULATIONS, 2009 | 12 | - |
| VIOLATED SEBI (MERCHANT BANKER) REGULATIONS, 1992 | 0 | - |
| VIOLATED SEBI (MUTUAL FUNDS) REGULATIONS, 1996 | 5 | - |
| VIOLATED SEBI (PFUTP) REGULATIONS, 1995 | 18 | - |
| VIOLATED SEBI (PORTFOLIO MANAGERS) REGULATIONS, 1993 | 3 | - |
| VIOLATED SEBI (PROHIBITION OF INSIDER TRADING) REGULATIONS, 1992 | 66 | 2 |
| VIOLATED LISTING AGREEMENT | 21 | - |
| VIOLATED SEBI ACT, 1992 | 20 | - |
| VIOLATED SEBI DEPOSITORIES ACT, 1996 | 0 | - |

| | | |
|---|---|---|
| VIOLATED SEBI PREFERENTIAL ISSUE GUIDELINES | 8 | - |
| VIOLATED SEBI PUBLIC ISSUE GUIDELINES | 27 | - |
| VIOLATED SEBI REGULATION REGARDING DEMATERIALISATION/DEPOSITORY PARTICIPANTS | 69 | 1 |
| VIOLATED SEBI RIGHTS ISSUE GUIDELINES | 2 | - |
| VIOLATED SEBI TAKEOVER CODE, 1997 | 356 | 16 |
| VIOLATED SECURITIES CONTRACTS (REGULATION) ACT, 1956 | 8 | - |
| VIOLATIONS SPECIFIED IN EARLIER SEBI ORDERS/CIRCULARS | 11 | - |
| **TOTAL** | **1226** | **30** |

Source: The SEBI violations were adopted from www.watchoutinvestors.com web server. The complete table is compiled by the researcher.

**Table 2**

**Selection of Sample Companies**

| Criterion | No. of Companies |
|---|---|
| **Companies violating the SEBI regulations as on 31st March, 2013** | **1,226** |
| Less: Duplicate Records | (246) |
| Companies not within study period | (25) |
| Companies indirectly involved | (41) |
| | |
| **Preliminary Sample** | **914** |
| Less: Private Companies | (14) |
| Co-operative Companies | (3) |
| Trusts | (1) |
| Companies not listed on BSE | (376) |
| Suspended companies | (269) |
| Companies for which Market Cap. Missing | (101) |
| Control Company within match bracket not found | (30) |
| Companies with inadequate data | (36) |
| Defunct companies | (1) |
| Companies in other industries | (53) |
| **FINAL SAMPLE** | **30** |

Source: Researcher's compilation

**Table 3**

**Criteria for Selecting Control Companies**

| Criterion | Description |
|---|---|
| **Stock Exchange** | The company must be trading on the same national stock exchange which is the BSE in the present study. |
| **Company Size** | The company size is measured as the market capitalization of the company. The control companies listed on the BSE were chosen if they had market capitalization ± 30 percent of market capitalization value of the corresponding sample company. |
| **Industry** | The companies must belong to the same industry as classified by the National Industrial Classification (NIC) code prescribed by the Central Statistical Organization, Ministry of Statistics and Programme Implementation, Government of India. The companies classified according to 5 digit NIC code meeting the above criteria were selected as control. In cases where a control company could not be located from the corresponding 5 digit NIC code, companies matching 4 digit or 3 digit NIC code were selected. |
| **Time Period** | The companies identified on the basis of above mentioned three criteria were included in the final sample if data was available for the period in which sample company's illegality was reported. |

Source: Researcher's compilation

**Table 4**

**Comparison of Sample Companies with Control Companies**

| | Median | | Difference in Median *(z)* |
|---|---|---|---|
| | **Sample Companies** | **Control Companies** | |
| **Profit after tax** *(in millions)* | 498.00 | 936.17 | -0.442 (0.658) |
| **Total assets** *(in millions)* | 9500.82 | 125440.15 | -0.072 (0.943) |

Source: Researcher's compilation

Notes:  The differences of median are based on a two-tailed test.

Figures in parenthesis are probabilities.

**Table 5**

**Comparison of Sample Companies and Control Companies**

| Variables | | OUT_DIR | BRD_SIZE | BRD_MEET | BRD_BUSY | GROWTH (in millions) | AGE |
|---|---|---|---|---|---|---|---|
| **PANEL A: Descriptive Statistics for Sample and Control Companies** | | | | | | | |
| **Full Sample** | Min | 29 | 4 | 3 | 0 | -90 | 0 |
| | Max | 100 | 14 | 19 | 9 | 235 | 30 |
| | Mean | 53.43 | 7.08 | 7.57 | 2.60 | 23.02 | 16.45 |
| | Median | 0.50 | 7.00 | 6.00 | 2.00 | 8.00 | 16.50 |
| | S.D. | 13.536 | 2.353 | 3.837 | 2.044 | 47.24 | 7.892 |
| **Sample Companies** | Min | 29 | 4 | 4 | 0 | -90 | 0 |
| | Max | 75 | 14 | 19 | 9 | 235 | 30 |
| | Mean | 48.37 | 6.83 | 7.83 | 2.37 | 21.40 | 17.57 |
| | Median | 50 | 6.50 | 6.00 | 2.00 | 9.00 | 17 |
| | S.D. | 11.839 | 2.394 | 4.276 | 2.236 | 54.523 | 6.816 |

| | Min | Max | Mean | Median | S.D. |
|---|---|---|---|---|---|
| **Control Companies** | 33 | 100 | 58.50 | 56.50 | 13.398 |
| | 4 | 14 | 7.33 | 7.00 | 2.324 |
| | 3 | 16 | 7.30 | 6.50 | 3.395 |
| | 1 | 8 | 2.83 | 2.00 | 1.840 |
| | -28 | 131 | 24.70 | 7.66 | 39.21 |
| | 1 | 29 | 15.33 | 16 | 8.814 |

**PANEL B: Difference in Median between Sample and Control Companies**

| Variables | OUT_DIR | BRD_SIZE | BRD_MEET | BRD_BUSY | GROWTH (in millions) | AGE |
|---|---|---|---|---|---|---|
| **Difference in Median ($Z$)** | -2.739 | -1.195 | -0.404 | -0.993 | -0.022 | -1.006 |
| | (0.005) | (0.232) | (0.686) | (0.321) | (0.983) | (0.314) |

Source: Researcher's compilation

Notes: The differences of median are based on a two-tailed test.

Figures in parenthesis are probabilities.

**Table 6**

**Correlation Matrix and Multicollinearity Statistics (N=60)**

| | Variables | VIF (Tolerance Values) | 1 | 2 | 3 | 4 | 5 | 6 | 7 |
|---|---|---|---|---|---|---|---|---|---|
| 1 | ILLEGALITY | - | 1 | | | | | | |
| 2 | OUT_DIR | 1.025 (0.975) | -0.399*** | 1 | | | | | |
| 3 | BRD_SIZE | 1.037 (0.964) | -0.119 | -0.059 | 1 | | | | |
| 4 | BRD_MEET | 1.116 (0.896) | 0.060 | 0.066 | 0.229 | 1 | | | |
| 5 | BRD_BUSY | 1.116 (0.896) | -0.163 | -0.052 | 0.189 | -0.034 | 1 | | |
| 6 | GROWTH | 1.057 (0.946) | -0.083 | -0.078 | 0.126 | 0.138 | 0.044 | 1 | |
| 7 | AGE | 1.164 (0.859) | 0.110 | 0.007 | -0.066 | -0.108 | 0.336*** | -0.059 | 1 |

Source: Researcher's compilation

Notes: Dependent Variable: ILLEGALITY is a binary variable with the value of 1 for sample companies and 0 for control companies.

*** $p = 0.01$

** $p = 0.05$

* $p = 0.10$

**Table 7**

**Results of the Logit Regression Model for Full Sample**

| Variables | Coefficient | *p*-value |
|---|---|---|
| OUT_DIR | -1.136[**] | 0.004 |
| BRD_SIZE | -0.318 | 0.301 |
| BRD_MEET | 0.327 | 0.303 |
| BRD_BUSY | -0.579[*] | 0.084 |
| GROWTH | 0.167 | 0.583 |
| AGE | 0.626[*] | 0.063 |
| Constant | -0.044 | 0.885 |
| N | 60 | |
| -2 Log likelihood | 66.165 | |
| Cox & Snell R Square | 0.232 | |
| Nagelkerke R Square | 0.310 | |
| Chi-Square (6 d.f.) | 15.609[**] (0.016) | |
| Hosmer & Lemeshow Test (8 d.f.) | 4.176 (0.841) | |
| Percentage Accuracy | 74.6 | |

Source: Researcher's compilation

Notes: Dependent Variable: ILLEGALITY is a binary variable with the value of 1 for sample companies and 0 for control companies.

Figures in parenthesis are p-values.

*** $p = 0.01$

** $p = 0.05$

* $p = 0.10$