ABSTRACT

The problem of corporate frauds has engulfed the corporate world around the globe. The instances of corruption, money laundering, tax evasion, loan defaults, and insider trading are pervasive and ubiquitous. Nations, whether developed or developing, have felt the economic jolt more than once. The infamous cases of WorldCom, Enron, Adelphia, and Lehman Brothers in United States of America, Polly Peck, Barings Bank, MG Rover Group, and Northern Rock in United Kingdom, Parmalat in Italy, Harshad Mehta scam, Ketan Parekh scandal, Satyam Computers, Sahara Group, and Kingfisher Airlines in India, One. Tel, Bankwest, and Storm Financial in Australia, and the like have left the global investors quivering. The corporate collapses entail humongous economic loss to the stakeholders and perpetual loss of trust in the financial system. Even though the phenomenon of corporate wrongdoing is not recent, it is interesting to note that the issue of corporate illegalities has ignited consciousness only in the past few decades.

Considering the enormity of corporate scandals, the policy makers, corporate activists, and regulatory agencies have comprehensively examined the problem of frauds and attempted to contain it through the advent of corporate governance. In the same vein, academicians have investigated the effect of corporate governance dimensions on the corporate frauds. Since the board of directors and the audit committee are the cardinal elements of the company’s governance framework, the existing literature has evinced the relationship of board composition and audit committee characteristics with corporate illegality. However, a scrutiny of studies on illegality brings forth the gap in literature which subsists in the Indian context. To the best of the researcher’s knowledge, there is no scholarly work which addresses the issue of corporate governance effects on corporate illegality in India. Thus, looking into the gravity of the problem and the paucity of literature in the Indian corporate set up, the present research endeavours to develop an association between corporate governance and corporate illegality in the Indian companies. Furthermore, the study draws a contrast between the corporate governance attributes of companies with and without illegality. Lastly, an industry-by-industry comparison is made among sample
companies across four Indian industrial segments, i.e., financial services, manufacturing, wholesale and retail trade, and business service industry.

The present study is conducted for a period of five years, i.e., from 1\textsuperscript{st} April 2008 to 31\textsuperscript{st} March 2013, on the companies alleged of violating the statutory regulations stipulated by the chief securities market regulator, \textit{viz}, the Securities Exchange Board of India (SEBI). The universe of the study comprises of 1,226 companies of which 71 sample companies are examined after a through sample selection process. For a comparative analysis, a set of 71 control companies is matched to the sample companies. The control companies are paired to the sample companies based on the criteria laid by Beasley (1996) with respect to the same stock exchange listing, similar firm size, same industry, and data availability.

The variables under study include board composition and audit committee characteristics as independent variables and corporate illegality as the dependent outcome variable. The board composition variables examined include the proportion of independent directors and grey directors on the board, board size, board meetings, CEO duality, and multiple directorships. The audit committee variables comprise of the proportion of independent members on the committee, audit committee size, and audit committee meetings. Besides, three control variables are investigated to measure their effect on corporate illegal events, i.e., company’s growth, institutional investor equity holding, and company’s age. The list of illegality companies is retrieved from the website Watchout Investors (http://www.watchoutinvestors.com). The data for the dependent variables is collected from the corporate database Prowess (maintained by the Centre for Monitoring the Indian Economy) and the reports filed by companies with the Bombay Stock Exchange (https://www.bseindia.com) and on their personal corporate websites.

For analysing the difference in the companies with and without illegality, univariate, bivariate, and multivariate statistical techniques have been used. The descriptive statistics, \textit{viz}., the mean, median, standard deviation, and minimum and maximum values, aid in construing the difference in the corporate governance profile of the sample and the match (control) companies. Owing to the log-normal nature of data, the non-parametric bivariate tests are applied to check the relationship between
the dependent and independent variables. The Spearman’s correlation and Mann-Whitney U test (Wilcoxon Ranks Sum Test) are used for bivariate analysis. Logistic regression analysis is employed as the multivariate tool to ascertain the influence of corporate governance variables on corporate illegality. Three logistic regression models are developed following the existing literature. The first model is the Corporate Governance Model which comprehensively tests the effects of board composition and audit committee variables on the likely occurrence of illegality. The second model, i.e., the Board Composition Model gauges the impact of board structure variables stand alone. The third model, i.e., the Audit Committee Model measures the relationship between audit committee variables and corporate illegality.

The regression coefficients for board composition reveal a negative association of board size, and multiple directorships with corporate illegality. A positive relationship is recorded for board meetings and CEO duality with illegality. With regards to audit committee variables, its independence shows a negative and statistically significant link with illegal events. Only one control variable, i.e., institutional investor demonstrates a substantial influence in determining the incidence of illegality in Indian companies. However, no significant relationship is seen for board independence, grey directors, audit committee size, audit meetings, growth, and age of the company. An examination of the companies with illegality showed that companies in the manufacturing industry retain the greatest share of assets, income, profit, and market capitalization, and the vice-versa is experienced in the wholesale and retail industry. It is also established that the maximum concentration of corporate illegality remains in the manufacturing industry and the wholesale and retail industry. Further, it is established that there exists a significant difference in the audit committee independence of illegality and non-illegality companies across all industries under the study.

The findings of the study clearly explicate that the corporate governance characteristics of a company are relevant in explaining the likelihood of illegal events in the Indian companies. This brings forth implications for theory as well as practice. Theoretically, readers will be able to appreciate the relationship of board and audit committee attributes with corporate illegality in the light of corporate governance
theories. The present study will assist investors in making sound investment decisions by evaluating companies on their corporate governance structure and their probability to engage in illegality. The results will also aid the regulators to identify the concentration of illegality based on industry characteristics. It is likely, that lawmakers may initiate changes in the current corporate governance regulations to check the instances of illegality.

In spite of the research limitations of restricted data availability, small sample size, and examination of select corporate governance variables, this research prompts for future study. The prospective areas include testing the linkages between corporate illegality in the private sector, with a bigger sample size, and its’ dependence on company’s ownership structure.