Corporate Governance

Divergence or convergence: paradoxes in corporate governance?
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Abstract

Purpose – *This review paper aims to compare the various dimensions in the finance literature pertaining to the Anglo-Saxon Model (Stockholder Model) prevalent in the USA and the UK with the German Model (Stakeholder Model) of corporate governance prevalent in Germany and continental Europe. The present study identifies different strands of research on the various dimensions of these models, along with aspects of governance in emerging economies and the phenomenon of the convergence of these governance mechanisms.*

Design/methodology/approach – *The literature review on corporate governance models has been carried out on the themes of internal and external governance mechanisms. The review considers agency theory along with principal–principal (PP) conflicts as the fundamental blocks explaining the need for governance structures.*

Findings – *The traditional models of governance, along with the incorporation of PP conflicts, will result in a hybrid model inculcating the best of both the traditional models. However, convergence in the true sense may not be possible owing to fundamental differences pertaining to cultural, economic, legal and socio-economic aspects of the firm.*

Originality/value – *This paper proposes a framework incorporating the interplay of managerial talent and controlling shareholders to understand the governance system that may be applicable for firms in emerging economies.*

Keywords *Corporate governance, Emerging markets, Comparative corporate governance, Divergence, Economic convergence, Principal-principal conflicts*

Paper type *Literature review*

1. Introduction

Globalization of the world economy and integration of financial markets have brought the traditional models of corporate governance at the crossroads. The discourse on the convergence of governance models, which has resulted from the integration of economic systems across the world along with other developments, has gained importance amongst practitioners and academicians. The present study reviews the arguments in the existing literature on various dimensions in the finance domain and the phenomenon of convergence of the traditional models of corporate governance. The study focuses on Anglo-Saxon Model (Stockholder Model) prevalent in the USA and the UK and the German Model (Stakeholder Model) of corporate governance prevalent in Germany and continental Europe. It also draws on the aspects of governance as reported in certain emerging economies.

Convergence refers to the gradual movement of policies and practices towards a common point. The different dimensions of studying the phenomenon of convergence can be the source, learning process followed, underlying assumptions, content and structures of the policy under study. The perfect alignment of these dimensions promises seamless convergence (Steane, 2001). In this context, the review, while identifying the forces and challenges to the process of convergence as discussed in the existing literature, attempts

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to draw up a framework for a study of governance mechanisms. This could have important implications for corporations and policymakers across the world, especially in emerging economies.

The review paper has been structured as follows: Section 2 discusses the existence of agency problems justifying the need for establishing strong governance structures. Section 3 explains the existing traditional models of governance and their functioning. Section 4 articulates the dimensions of the governance models (internal control mechanism and external control mechanism), pertaining to divergence as documented in the literature. Section 5 reviews the forces of convergence, possibilities of attaining convergence and the inherent challenges. Section 6 concludes the study.

2. Agency theory: need for governance structures

2.1 Principal–agent conflict

Agency relationship, according to the contract view, is defined as:

> [. . .] contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal (Jensen and Meckling, 1976).

The positivist agency theory identified the governance mechanisms in the principal–agent (PA) relationship to limit the self-serving behaviour of the agents (Eisenhardt, 1989). Also, the positivist economists have identified and explored the uniqueness of the PA relationship in the form of shareholders (owners) and the managers (agents) in large public and modern organizations (Berle and Means, 1932). Owing to inherent conflict of interest in the relationship and the problems in designing the contracts, wherein the parties specify the allocation of control rights over various dimensions of assets, the division of residual control rights between the managers and owners has to be carried out efficiently and effectively (Grossman and Hart, 1986). The presence of such allocation issues between the parties to the contract gives rise to the need for having governance mechanism addressing the conflicts.

2.2 Principal-principal conflict

The firms in the emerging economies are characterized by concentrated ownership structure, family-controlled business, presence of business group structures and low investor protection for minority shareholders. Hence, the unique firm characteristics and institutional context give rise to conflict of interest between majority (controlling) shareholders and minority shareholders, referred to as principal–principal (PP) conflict.

Young *et al.* (2008) modelled the antecedents and the organizational outcome of the PP conflicts in the emerging economies. The authors emphasize that the solutions in the form of governance structures applicable to PA conflicts prove to be ineffective in providing solutions to the PP conflicts. Governance structures need customization to deal with the unique characteristics of the emerging economies.

Table I highlights how the country-level variables of economic development and ownership concentration can affect the presence of external and internal governance mechanism resulting in interplay between the existence of PP conflicts and PA conflicts. Generally, the developed economies are characterized by low ownership concentration and strong external governance mechanisms in the form of investor protection laws and institutions. Such an environment leads to conflict of interest between the shareholders and managers (agents). On the other hand, in emerging economies, the ownership structure is concentrated and external governance mechanisms are not strong enough to protect the minority shareholders. In this scenario, PP conflicts are more pronounced. Hence, various

Table I Agency theory and nature of conflicts

Economic development	*Ownership concentration*	*External governance mechanism*	*Internal governance mechanism*	*Nature of conflicts*[a]
Developed	Low	Strong	Strong	PA $>$ PP
	High	Strong	Weak	PA $\neq$ PP
Emerging	Low	Weak	Strong	PA $\neq$ PP
	High	Weak	Weak	PA $<$ PP

Notes: [a]PA, principal–agent conflicts; PP, principal–principal conflicts

governance mechanisms are expected to lead to varied nature of conflicts, which eventually can affect the cost of capital and firm performance.

The literature on corporate governance provides evidence of existence of other theories, which suggest alternate explanations for corporate governance structures. The major competing theories are stewardship theory, managerial hegemony, resource dependency theory, stakeholder theory and multi-governance theory (Daily *et al.*, 2003; L'Huillier, 2014). However, in the absence of an overarching theory, agency theory is the dominant theory in corporate governance literature.

3. Models and mechanism of corporate governance

Corporate governance refers to the procedures through which the capital providers to the firm guarantee themselves of getting a return on the invested capital (Shleifer and Vishny, 1997). It can also be considered as the system of guidelines, rules and factors, which control the methods used for performing various operations in the organization (Gillan and Starks, 1998). Corporate governance mechanism is considered to be a nexus of contracts (Jensen and Meckling, 1976). Hence, the governance mechanism includes the systems pertaining to regulations and laws, which ensure the absence of misbehaviour by the agents, efficient and effective utilization of the finances provided by the investors. The corporate world is often found to be focusing on the corporate governance models and mechanism that have been prevalent in various economies over decades. To promote fair dealings and communicate quality information to the investors, different countries, on the basis of their macro and microeconomic variables, have enforced corporate governance codes and have adopted various models of corporate governance. For instance, the emerging economies (BRIC nations) differ from the developed economies on many dimensions such as relation versus rule-based governance, ownership structures, institutional development and enforcement of laws and regulations (Peters *et al.*, 2011).

Corporate governance mechanism exists in many forms and adaptations globally, depending on micro as well as macroeconomic variables, institutional and political set-ups. On the basis of classification of the two types of financial systems, namely, the capital market-dominated and bank-dominated, there exist two types of distinct corporate governance models:

1. Anglo-Saxon governance model.
2. German–Japanese governance model.

The models are at opposite ends of the spectrum with "Stockholder Model" (external control exercised by the stockholders in the firm) and the "Stakeholder Model" (internal control exercised by the various stakeholders such as creditors, bankers, employees, etc.) being the two extremes.

"Anglo-Saxon" type or "capital market" or "Stockholder Model" (Jeffers, 2005) of governance mechanism is prevalent in the USA and the UK. The firms with this mechanism of governance in place are dominated by the objective to maximize shareholder wealth. The main dimension of analysing firm performance is market value. These countries have a long tradition and history of democracy and capitalism, which, in turn, promotes the private ownerships in the business. Shareholders, who play a central role in this governance system, are the owners of the corporations, as they invest funds in the organizations and have a right to control the firms. However, to effectively manage the firms and avoid incongruity, a "Board of directors (BOD)" is appointed to carry out managing activities in the business, which is continuously monitored by the shareholders externally. The BOD, in turn, delegates the managing activities to the management of the company and closely monitors and evaluates the performance of managers. In such a model, the control system internal to the organization is heavily dependent on the BOD as the:

> [. . .] board, at the apex of the internal control system, has the final responsibility for the functioning of the firm and the job of the board is to hire, fire, and compensate the CEO, and to provide high-level counsel (Jensen, 1993).

"German Model" or "Stakeholder Model"(Jeffers, 2005) is prevalent in Germany and continental Europe, which differs from the USA and the UK in social, economic, judicial and cultural dimensions. In the German society, the emphasis is not only on the shareholder value maximization but also on the costs and benefits that accrue to the society out of the operations of a corporate house. Essentially, the businesses are managed taking into consideration the welfare of various stakeholders including the workforce, creditors, suppliers and society. The corporations in the model are characterized by a large block of shareholding controlled by large institutions such as financial institutions, banks and public shareholding. In this mechanism, the corporations are also not prone to hostile takeovers unlike the corporations in the market-based governance systems. The model is characterized by the system of governance, wherein the board exists in two parts, namely, the management board and supervisory board, without any overlap of the members of these boards.

Essentially, the governance models in vogue across the globe adopted by various countries do not belong to the two extreme ends of the continuum; rather they lie somewhere in between these two extremes according to the legal, social, economic and cultural dimensions of the nations.

4. Divergent dimensions: corporate governance models

Often, the researchers have viewed the governance mechanism to be classified into two categories, namely mechanisms:

1. internal to the firm; and
2. external to the firm (Brown *et al.*, 2011; Gillan, 2006).

While the internal dimensions or characteristics are affected by the actions or decisions of the parties, which are internal to the organization, external parties or forces affect the external mechanism of corporate governance.

4.1 Internal mechanism

The two governance models differ in their internal mechanism to a huge extent. The major dimensions of the internal control mechanism are as follows:

4.1.1 Board: structure, composition and role. The BOD occupies a pivotal role in the governance mechanism. According to Nikolic and Erk (2011):

> [. . .] the main role of the board of directors as an internal corporate governance mechanism is to define the strategic orientation of a corporation, to provide monitoring and control of management in order to satisfy the owners' and key stakeholders' interest.

The main role of BOD is monitoring, leading to reduction in the agency cost and resolution of conflict of interest. The prime role of BOD is to resolve manager–shareholder agency issues (Fama and Jensen, 1983). The findings of Mace (1986) suggest that boards are not concentrating on the supervisory or monitoring roles. Research studies on the disciplinary role of BOD also have diverse viewpoints. According to Lorsch and MacIver (1989), BOD are generally passive and seldom play a significant role in maintaining discipline. Survey results of Demb and Neubauer (1992) are also on similar lines. However, it has been observed that the board has shed its passivity and dependence. In the 1990s, BODs have become committed and unrestrained of the firms' management in aligning the organizational strategy to investors' objectives (MacAvoy and Millstein, 1999).

Significant research has been done on the linkages between composition and degree of independence of corporate boards. It is presumed that the presence of independent and outside directors contributes towards the boards' independence. In the context of takeover bids, the results of empirical research suggest a positive relationship between the proportion of independent outside directors and abnormal returns of the bidder except for the very high proportion of independent outside directors (Byrd and Hickman, 1992). The results of the study provide evidence for the monitoring role of independent directors. However, a competing view based on the "managerial quality hypothesis", suggest that it is the association between the presence of independent outside directors and the managerial quality that affects the stock returns rather than the monitoring role of directors. The empirical evidence on the relationship between firm performance and CEO turnover suggests an inverse relation for firms with higher proportion of outside directors (Weisbach, 1988). Further analysis shows a negative relationship between CEO shareholding and the number of outside directors.

In Germany and Japan, the large block of debtholders directly affects the working through board membership and performs separate functions from the large shareholders (John and Senbet, 1998). Also, unlike the USA, in German firms, the employees are also part of the boards. The studies suggest (Goergen *et al.*, 2008) that, in a reasonable number of German firms, "managers own" and "owners manage", as there is no separation of ownership and control. An inverse U-shaped relationship had been found between the value of the German firms and the employee representation on the board (Fauver and Fuerst, 2006). The two-tier boards dominate the German–Japanese model of governance with a clear distinction between the supervisory board (consisting of employees and shareholders) and the management board (includes the executive directors). Studies have shown that there is no relation between the existence of two-tier board structure and quality of corporate governance (Franks and Mayer, 2001). On the other hand, contrary to other research findings, empirical results also suggest that there is no significant economic impact of board composition on firm performance (Hermalin and Weisbach, 1991). The emerging economies are characterized by family-based systems, concentrated ownership, pyramidal structures and lesser-developed capital markets. In the context of emerging economies, with a special reference to the Turkish-listed firms, Oba *et al.* (2014) suggested that firms have smaller boards with non-executive members and occasional CEO duality.

4.1.2 Managerial incentives. Managerial remuneration is the principal tool for aligning the objectives of managers and shareholders to reduce agency costs and to avoid conflict of interest. The two governance models differ in the managerial incentives structure and forms to a great extent, accounting for a distinction between the two corporate governance models. A comparison of the CEO compensation structure at the beginning of the century in 2000-2001 reflects that the pay package of German CEOs was significantly lesser than that of the US counterparts. The contribution of the basic compensation (other components being variable, pay, benefits and perquisites) was found to be 47 per cent for the German CEOs as compared to 28 per cent for US executives (Goergen *et al.*, 2008). However, the reforms in the governance models suggest that the German firms are moving towards the increased variable pay component in the CEO compensation structure (Tuschke and Gerard Sanders, 2003). The authors also suggested a non-monotonic relationship between reform initiatives of the governance structures and ownership concentration. However, the compensation structure of executives in the USA has undergone similar reforms much earlier. Apart from the manifold increase in the compensation structure, the contribution of option-based compensation has increased to an even higher degree. The increase in the equity-based compensation in the USA has invited discussions both in favour of and against the shift. The academic, as well as corporate community, emphasized on a dual effect of the shift, as it is expected to align the interests of shareholders and managers, while a counter argument suggests that the shift might increase the conflict of interest between the two parties (Holmstrom and Kaplan, 2003).

4.1.3 Ownership structure. The literature related to the monitoring incentive of the stockholders emphasizes that large stockholders are better monitors as compared to the small and diffused stockholders because, for small blockholders, the cost of monitoring outweighs the benefits of monitoring (Shleifer and Vishny, 1986). The research undertaken in the context of anti-takeover amendments points out that affiliation of the blockholders affects their monitoring effectiveness (Borokhovich *et al.*, 2006). The empirical results of the research suggest that the abnormal returns are higher for the firms with higher proportion of unaffiliated blockholders. With reference to the ownership and capital structure, the Anglo-Saxon model of governance essentially has dispersed ownership, hence weak monitoring by the shareholders. In the German Model, the ownership is concentrated, resulting in stronger control by the shareholders. Dispersed ownership structures give rise to more agency problems because of lack of incentives to monitor the firm by the dispersed shareholding. Studies have shown that countries adopting a "stockholder model" or the "outside model" have dispersed structures, while the countries with "stakeholder model" or the "insider model" are found to have a concentrated ownership (La Porta *et al.*, 1999). Ownership concentration is larger in the Japanese firms than the US firms, with financial institutions holding large blocks of shares. Hence, the "stakeholder model" of corporate governance in Japan depends essentially on the direct monitoring resulting from the concentrated ownership structure than in USA (Prowse, 1992). However, in the USA, Bank Holding Companies Act (1953) and Glass–Steagall Act (1993) do not permit banks to have equity holdings in the non-financial corporations on their own account (Weimer and Pape, 1999). The differences in the corporate governance models also relates to the minority shareholders rights and liabilities, as the minority shareholders are more prone to expropriation by the majority stockholders in the German firms than in the US firms (Lazarides and Drimpetas, 2010). Table II summaries the divergent dimensions of the internal control mechanism of the traditional corporate governance models.

4.2 External control mechanism

The firms' decisions pertaining to implementing best governance practices are also a function of financial development, economic development, legal protection laws and financial globalization of the country. The results of a study by Doidge *et al.* (2007), suggest that the changes in the governance ratings of the firm are better explained by country-level variables rather than firm-level variables. Authors are of the view that the firms in lesser-developed countries have little or no motivation to incur cost on implementing better governance structures because of lesser developed financial markets and state investor protection laws. Hence, the external control mechanisms, which are assumed to be beyond the control of the firm, can affect the governance structure significantly. Financial

Table II Summary of the internal control mechanism of corporate governance models

		Internal control mechanism of corporate governance models	
S. no.	*Dimensions*	*Stockholder model*	*Stakeholder model*
1.	Board composition	Single-tier board Higher Board Independence	Two-tier board Lower independence and presence of stakeholders on board
2.	Managerial incentives	Higher total CEO remuneration Higher variable component and equity based compensation	Lower total remuneration and higher fixed component
3.	Ownership structure	Dispersed ownership structure and weak monitoring	Concentrated ownership structure and direct monitoring by large blockholders

globalization could also necessitate the adoption of governance mechanisms in such countries. The financial, legal and regulatory mechanisms form the elements of the external control mechanism.

The financial systems are classified into market- and bank-based systems. The key differences in the corporate governance systems emanate from the characteristics of the two financial systems. In bank-based financial systems, banks exert a major influence on the working of the corporations. The study by Favarra (2003) examined the relationship between financial development and economic growth. The study suggested a weak relationship between financial development and economic growth and indicated that banks are not the only financial institutions to park excess funds, rather they also play a vital role in allocating and mobilizing funds, monitoring the corporations and in risk management. Hence, the stakeholder model of Continental Europe and Japan is considered to be better equipped in implementing policies involving relations with stakeholders, while the Anglo-Saxon model is considered to be more responsive to change (Mayer, 1998). However, La Porta *et al.* (1997) emphasize that the legal system of a nation is the main antecedent for the efficacy of financial systems.

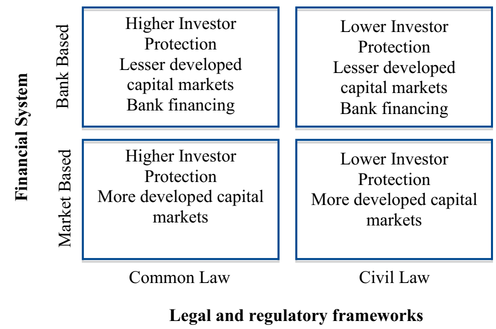
The legal system is defined as a system which "ensures a minimum of compliance with the stakeholders/shareholders standards of corporate governance" (Lazarides and Drimpetas, 2010). Essentially, the legal system around the globe is divided into Common Law and Civil Law, which defines the rights and the protection mechanism for the investors (majority as well as minority shareholders) in the different financial systems. For instance, India has a legal system based on common law and having a bank-based model as compared to Brazil, which has civil law-based legal system with a market-based model of governance (Demirgüç-Kunt and Maksimovic, 2002).

Research by La Porta *et al.* (1997) analysed external financing in 49 countries with respect to origin of their legal frameworks to study the level of investor protection enforced by the judicial system. The results of the study suggested that the common law countries are found to have an effective enforcement of investor protection laws along with more developed capital markets as compared to civil law countries. Hence, the legal system of country defines the type of corporate governance systems in place in that particular country and might also pose a challenge to the unification of the governance systems around the globe. Matoussi and Jardak (2012) empirically tested the data on 81 emerging and developed countries and explained the antecedents of investor protection and its consequences impacting the financial markets across various countries considering legal, political and cultural variables. According to La Porta *et al.* (2000), "the legal approach is a more fruitful way to understand corporate governance and its reform than the conventional distinction between bank-centered and market-centered financial systems". The authors posit that the strong legal protection provides greater security to the investors against political interference, leading to effective corporate governance, more developed capital markets, diffused ownership and adequate allocation of capital. The historical legal origin of the countries affects regulations and laws systematically and differences in the legal rules eventually affect the social and economic outcomes (López de Silanes, 2008). Figure 1 summarizes the features of external governance mechanism for various financial systems along with legal and regulatory frameworks.

5. Corporate governance convergence: possibilities and challenges

Globalization of world economy and the increased competition in the global markets has resulted in increased prospects of confluence of the corporate governance models. The literature emphasizes on the convergence of the ideas regarding the best or optimal governance structures. However, the implementation of the ideas or written governance codes is subject to the country-level characteristics supporting the idea of partial convergence (Aoki, 1994; Bebchuk and Roe, 1999). In the context of transition economies,

Figure 1 Summary of the external governance mechanism of corporate governance models



the transition has been initiated with regard to dimensions of the internal governance structure such as managerial remuneration and board structure.

Initiatives have been taken at different levels by various agencies such as Organization for Economic Co-operation and Development (OECD) to integrate the corporate governance codes across the globe by establishing principles for good corporate governance. The transition is taking place in both market-based (such as decrease in the take-over activity in Anglo-Saxon countries) and network-based models of corporate governance (such as criticisms for interlocking board seats), and these transitions are analysed to be converging in character (Weimer and Pape, 1999). OECD countries are also showing a pattern of convergence as the globalization of economies with integration of capital markets have forced the firms to compete in the international markets leading to convergence of product costs, structural organization of the firms and financing patterns (Stiplon and Thompson, 2001). Martynova and Renneboog (2011) studied the legal reforms by developing three new corporate governance indices (dealing with different agency problems). The study concluded that there are significant reforms in the regulations since 1990 across all the countries under study; however, there were significant differences in the patterns of reforms such as reforms related to creditor protection and investor protection.

On the contrary, Davies and Schlitzer (2008) suggest that, although the corporate governance systems are in a constant phase of adaptation, the similarity and dissimilarity in the fundamental features, such as financial systems and socio-economic orientations raise a question on the possibility of convergence of the two models. The authors also suggest that the "one size fits all" approach is not the best solution to tackle the diverse dimensions. According, to Wojcik (2006):

> [. . .] the forces of competition and financial integration do operate, but before they make an impact on corporate governance in a specific place, they are "filtered" through existing, mostly nationally based institutions.

The political preconditions (Bhasa, 2004) argument suggests that divergence of the political ideologies of the nations makes it challenging for the nations to adapt to the models and systems of the other countries. The concept of path dependence (Schmidt and Spindler, 2002) has also argued that:

> [. . .] the dynamic properties of systems composed of complementary elements are such that a rapid convergence towards a universally best corporate governance system is not likely to happen.

Jeffers (2005) suggests that consequences of the progressive process of convergence would be influenced by the beginning point or the initial models adopted by the firms and the path followed towards convergence. In the context of economic transition, there is a possibility of formal convergence of corporate governance standards; however, the functional convergence of governance standards can be debated (Pistor *et al.*, 2000). The results of empirical analysis by Khanna *et al.* (2006) highlight that there is a high similarity of corporate governance standards of economically interdependent countries. Authors also report a high correlation between economic interdependence and the corporate governance standards, hinting on the absence of complete convergence. In a global context, *de facto* convergence (functional) lags *de jure* convergence, as *de facto* convergence can be affected by path dependence, multiple optima and rent-seeking behaviour of the stakeholders (Khanna *et al.*, 2006). The fundamental differences pertaining to legal, regulatory, economic and institutional environment of the economies have led to a "dual convergence", resulting in a hybrid model, which has borrowed, from both stakeholder model and shareholder model of governance.

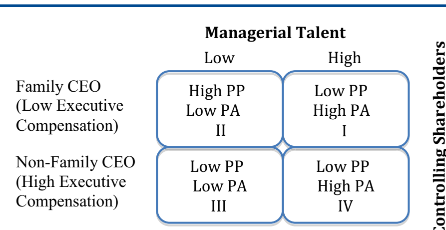
In the context of emerging economies, factors influencing demand for managerial talent in the firms include entry of foreign institutional investors (globalization), growth of multi-national companies (MNCs) and development of capital markets. Young *et al.* (2008) state that there are several consequences arising from PP conflicts dominant in emerging economies including managerial talent, mergers and acquisitions and tunnelling (self dealing). In emerging economies, while analysing managerial talent and executive compensation, based on the U-shaped relationship reported between executive compensation and ownership concentration (Core *et al.*, 1999; Zhongfeng Su *et al.*, 2010), we have made an attempt to propose a framework, wherein the firms in emerging economies can be classified into four clusters. Figure 2 describes a framework, wherein managerial talent and executive compensation can lead to co-existence of PP and PA conflicts in a concentrated ownership context.

Organizations in emerging economies are witnessing an increasing supply of managerial professionals, and the absorption of these into organizations in increasing. Presumably, educational institutions that offer professional degrees pertaining to this domain meet the supply of talent. Family CEOs control some of the organizations, and others could be controlled by non-family CEOs. Drawing on the study by Gomez-Mejia *et al.* (2003) which reports:

> [. . .] that family CEOs earn less than non-family CEOs in firms with concentrated family ownership.

We hypothesize that firms that are endowed with managerial talent and owned by family CEOs (who are likely to receive less executive compensation) are likely to be beset by principal–agent costs that are significantly high. Professional managers are presumed to be involved in activities that maximize shareholder value. This would include catering to the need of all shareholders (both minority and controlling shareholders). Hence, the minority shareholders are not likely to perceive a conflict with the controlling shareholders. This would result in a situation, wherein the PP conflicts are likely to be low. This is illustrated in Quadrant 1. Quadrant 2 represents a set of firms with family CEO and low managerial talent. For these firms, in the absence of managers who can protect the interest of minority shareholders, the possibility of minority shareholders being expropriated is high, leading to

Figure 2 Proposed framework on relation between executive compensation, managerial talent and agency conflicts in emerging economies



high PP conflicts. Firms with low managerial talent and non-family CEOs are expected to face lower PP conflicts, as the firm has a non-family CEO, whose presence will not let the controlling shareholders expropriate minority shareholders. At the same time, the principal–agent conflicts are expected to be lower, as the managerial talent is of lower quality. However, such firms exhibit lower performance in spite of low PP and principal–agent conflicts. Quadrant 4, presents the firms with low PP and high principal–agent conflicts, as they have non-family CEO (reducing the PP conflict) and high managerial talent, which increases the prinicpal–agent conflicts. Given the co-existence of PP–PA conflicts in emerging economies, the framework suggested above can help the policymakers and managers in understanding the precise role of various governance mechanisms. Hence, in emerging economies, there is a role for internal and external governance mechanisms manifesting themselves in differential degrees. Classifying the firms in emerging economies into four quadrants would herald the commencement of a relevant study that seeks to understand the significance of various governance mechanisms.

6. Conclusion

Good governance practices tend to positively impact the performance of firms. Across the globe, firms have been continuously working to adapt best governance practices in order to address PP and PA conflicts. The corporate governance models that have evolved and have been adopted in the various countries over the decades have differed on various dimensions, such as board's structure, and ownership patterns due to the unique set of socio-economic, cultural, legal and political dimension of the countries. Researchers suggest that the two models are converging due to prevalence of certain macro-economic forces. However, it has also been pointed out that the difference in the fundamental frameworks and financial systems of the countries make it difficult to see a convergence of these corporate governance models in the true sense. The governance structures at the firm level can be decoupled from the legal and institutional set-up of the countries, which provides a possible explanation for the patterns of convergence documented in the literature. For instance, despite weaker enforcement of laws in the emerging economies, firms are adapting best governance practices (Cornelius, 2005). Dual convergence of the traditional models with coexistence of PP and PA conflicts is expected to result in a hybrid model. The interplay between the forces to adapt best governance practices at the firm level and the differences in legal and institutional frameworks at the macro-economic level are expected to contribute towards the presence of convergence– divergence paradox in the future. Research on governance in emerging economies is engaged with aspects relating to agency conflicts and external governance mechanisms. The framework suggested in this paper is an endeavour to stimulate a research agenda in this direction.

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