Corporate Governance: Convergence v.s Divergence

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Abstract

Recent scandals have highlighted the importance of corporate governance. There are various corporate governance models worldwide. Popular models are Anglo-Saxon modal, Continental modal and Islamic model witch are discussed in this study. Moreover, Major challenge facing corporate governance globally is convergence of corporate governance. Also, this study discusses both drivers and impediments to convergence. Considerable differences exist across countries in the corporate governance mechanisms especially, among western and Islamic countries. Also, there are differences among western countries. the environmental characteristics create differences in corporate governance across countries and corporate governance changes are responses to environmental characteristics changes. These environmental factors impede to convergence and make divergence. They include religion, culture, path dependence and complementarities, resistance, view of the firm, financers and ownership patterns, Economic Development and type of business entities, and lack of consensus. In contrast, Integration of markets, institutional pressures and convergence of accounting standards are drivers of convergence.

Key Words: Corporate Governance, Convergence, divergence.

1. Introduction

Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. (OECD, 1999)

A country's corporate governance system has a significant impact on the profitability and growth of companies, their access to capital, and their costs of capital, decisions undertaken by firms and ultimately the wealth created in a country (Braendle and Noll, 2005). Recent corporate scandals have further highlighted the importance of corporate governance (Gillan and Starks, 2003).

Several scholars argued that the world is converging towards "outsider corporate governance". However, several factors militate against such a global convergence (Rossouw, 2009).

Considerable differences exist across countries in the corporate governance mechanisms. The corporate environmental characteristics affect corporate governance practices. Therefore, corporate governance changes simultaneously with the environmental changes (Gillan and Starks, 2003). Gillan and Starks (1998) argued that corporate governance changes are responses to environmental characteristics changes.

This study discussed both drivers and impediments to convergence. The rest of the paper is organized as follows: in section2 corporate governance models in world are presented. Then in section 3, convergence is defined and its drivers are discussed. Impediments to convergence are discussed in Section 4. Finally, Conclusion is presented in section 5.

2. Corporate Governance Models: western models v.s Islamic Model

2.1. Western Models

There are two polar systems of corporate governance in west: Anglo-Saxon model and continental model.

2.1.1. Anglo-Saxon Model (Outsider Model)

This system is found in the United States and the United Kingdom. Equity financing is a common method of raising capital in these countries. It is not surprising; therefore, they have the largest capital markets in the world. This system is called “market-base system”.

In these countries, equity is typically owned by widely dispersed groups of individual and institutional investors. The system favors use of the public capital markets and is designed to build confidence among non-controlling investors. The legal framework supports the right of shareholders to control the company and makes the board and the management accountable to the shareholders.

Therefore, primacy of shareholder interests is recognized in the company law and a strong emphasis on the protection of minority investors in securities law and regulation are characteristics of them. In these countries, there are strong requirements for disclosure. Regulation has been structured to provide relatively complete information to investors (Nestor and Thompson, 2002).

2.1.2. Continental Model (Insider Model)

In most other European countries, ownership and control are relatively closely held by identifiable and cohesive groups of "insiders" who have longer-term stable relationships with the company. Insider groups usually are small and have some connection to the company other than their financial investment, such as banks or suppliers. They typically include some combination of family interests, allied industrial concerns, banks and holding companies. Frequently, they can communicate among themselves with relative ease to act in concert to monitor management, which acts under their close control. This system is called “ blockholder-based system” and relies on codified law and emphasizes rules protecting stakeholders such as creditors and employees (Goergen, Martynova and Renneboog, 2005). But it excludes minority investors. Hence, the agency problem, which characterizes the outsider system, is of much less importance.

Patterns of corporate finance often show a high dependence upon banks than markets. Capital markets are less developed than in outsider systems. This system is more willing to accept selective exchanges of information among insiders. Insiders may control a company either by owning an outright majority of voting shares or by owning a significant minority holding and using some combination of parallel devices to augment their control over the company (Nestor and Thompson, 2002).

2.2. Islamic Model

In the Islamic view of corporate governance, the company directors’ management as well as the auditors should perform their duties for satisfying the shareholders and Allah as well. The aim of corporate governance is enhancing accountability, transparency and trustworthy. The values are paramount.

Banks are the key elements of the country's economy. Good Shariah governance is the very essence in the development of Islamic banking and finance sector. It guarantees the dynamicity of Islamic financial growth (Hasan, 2009).
The staff in Islamic bank should act according to Islamic principles and adhere to the teaching of Islam. Accounting standards in the Islamic bank should consider that Islamic banking is interest free banking and bonds are forbidden. The bank receives funds from the public assuming unrestricted Mudaraba. The bank cannot use the money to trade in non Halal activities. Banks should establish Shariah supervisory board and the internal control which supports it (Abdullah Saif Alnasser and Muhammed, 2012).
The financial conditions in Islamic banks are requiring additional items in the balance sheet, e.g. Zakat. In addition, it requires Shariah board to be established. It assures that transactions are performed in accordance to Shariah law. If the transaction is not according to Shariah rules the bank might lose social confidence (Abdullah Saif Alnasser and Muhammed, 2012). The interest of stakeholders may extend beyond the financial interest to ethical, religious or other values when requiring good corporate governance (Abdullah Saif Alnasser and Muhammed, 2012).

3. Convergence

Convergence means reducing international differences in corporate governance principles and practices (Doupnik and Perera, 2009). Convergence can be considered in two ways, namely, convergence in form and convergence in function (Gilson, 2004). Convergence in form is relating to increasing similarity in rules and regulations. When two countries adopt similar corporate governance laws and regulations, there is convergence in form. When actual practices converge, there is convergence in function. For example, all countries have regulations against bribery and corruption. That is, there is convergence in form. However, the actual prevalence of corrupt practices and enforcement of the rules against such practices vary significantly across countries, suggesting that there is no convergence in function (Yoshikawa and Rasheed, 2009). Therefore, convergence in form may not necessarily lead to convergence in function. It depends on enforcement of the rules and regulations across countries (Doupnik and Perera, 2009). Proponents of functional convergence would argue different institutions are equally capable of performing corporate governance functions such as ensuring management accountability. To the extent that it is possible, it is much less costly to improve corporate performance by working within the current institutions than creating new institutions (Gilson, 2000). Therefore, nations may formally adopt corporate governance systems that look like that elsewhere, but the acceptance of the enshrined principles may significantly lag their codification. This may be for several reasons including a lack of understanding of what is implied by the good corporate governance, absence of complementary institutions needed to implements the principles, or simply poor enforcement (Khanna, Kogan and Palepu, 2006).
Totally, there are different theoretical possibilities to push convergence in form. Each of these drivers was explained below.

3.1. Integration of Markets (Globalization)

In recent decades, national financial markets have become more integrated. Financial market integration takes many forms including listing by firms from one country in the stock exchanges of other countries, increasing foreign portfolio investment, cross-border mergers, and acquisitions, and free capital flows across countries. Each of these has implications for convergence (Yoshikawa and Rasheed, 2009).

3.2. Institutional pressures

What drives the diffusion of the good corporate governance codes? Aguilera and Cuervo-Cazurra (2004) found that countries with weak shareholder protection, high government liberalization, and a strong

presence of foreign institutional investors tend to develop the codes. Legitimating pressures (when a country has weak shareholder protection rights) and efficiency needs because of market pressures drive the diffusion of the codes. Hence, their study suggests that both institutional and market pressures play a role in spreading the good corporate governance codes. Good governance codes can bring a firm considerable legitimacy.
Companies from countries with poor legal standards can secure a lower cost of capital by subjecting themselves to tighter standards, thus reducing the agency cost of external finance (Stulz, 1998). National differences in corporate governance cause loss of investors' confidence, which affects the availability and cost of capital. If the codes are similar across countries, then they become a driver of global convergence as well (Doupnik and Perera, 2009).

3.3. Convergence in Accounting Standards

One of the major problems that a firm faces when it decides to list in a foreign exchange is the need to restate its accounts following the standards prevailing in that country. Similarly, investors interested in making portfolio investments in other countries face the problem of understanding the accounting practices followed in that country. Difference in accounting standards is an impediment to capital flows across countries. This problem is currently being addressed by the development of international accounting standards by the International Accounting Standards Board (IASB).acquisition of a worldwide common accounting standard is aim of this effort (Tarca, 2002). It can facilitate the process of convergence, particularly through mandating uniform disclosure requirements (Coffee, 1999).

4. Divergence

Considerable differences exist across countries in the corporate governance. The corporate environmental characteristics affect corporate governance practices. Therefore, corporate governance changes simultaneously with the environmental changes (Gillan and Starks, 2003). Gillan and Starks (1998) argued that corporate governance changes are responses to environmental characteristics changes. These environmental factors impede to convergence and make divergence. They were discussed in the following subsections.

4.1. Religion

In Islamic countries, the social and business activities based are based on religious laws and regulations. Religion determines the nature of a country's financing systems. For example, Iranian companies have fewer long-term liabilities because of the forbiddance of bonds in Islam. Therefore, companies are generally financed by issue of common stocks (Mashayekhi and Bazaz, 2008). For an Islamic stock market, transactional transparency and absence of market manipulations, short selling, insider trading, contra deals and excessive financial exposure are essential, because such practices are immoral or unethical.
Abu-Tapanjeh (2009) compares Islamic principle of corporate governance with OECD principles. Governance structure in Islam do differ from the normal corporate governance in the standardization of rules which must obey the Shariah rules stated in the holy Quran where the governance structure should meet the expectations of Muslim community by providing Islamic acceptable financing mode.
Result is western corporate governance may be irrelevant to Islamic countries.

Table1

Islamic Principles	OECD principles
• Property as trust form shariah rules • Sole authority is shariah • Society as stakeholders • Accountability not only to stakeholders but also to god, the ultimate owner • Just and fairness of value • Equitable distribution of wealth to all stakeholders and disadvantage members ○ In the form of Zakat and Sadagat • Social and individual welfare with both spiritual and moral obligation • Sensation of equality • Islamic accountability to Falah and social welfare orientation • Haram/Halal in transaction	• The right of shareholders and key ownership function • Promotion of transparent and efficient markets with rule of law and division of responsibility • Basic shareholder rights • Participation of decision making at the general meeting • Structure and arrangement for corporate control • Ownership rights by all shareholders, including institutional shareholders • The equitable treatment of shareholders • Protection to minority and foreign shareholders • The role of stakeholder in the corporate governance • Creating wealth, job and sustainability of financially sound enterprise

4.2. Culture

Culture refers to the complex of meanings, symbols, and assumptions about what is good or bad, legitimate or illegitimate that underlies the prevailing practices and norms in a society (Licht et al., 2005). Hofsted cultural dimensions include individualism, power distance, uncertainty avoidance and masculinity. These dimensions can be used to describe the similarities and differences in cultures around the world. For example, Anglo-saxon cultural area is characterized by high individualism, low uncertainty avoidance, low power distance and moderate masculinity. In this area, secrecy is low and transparency is high and so, the level of disclosure is high. In the less developed countries, conservatism and secrecy is higher and there is no motivation to some action such as disclosure, auditing and transparency (Hofsted, 1980). However, In Islam masculinity is prevalent and women are seen as device for men.

4.3. Path Dependence and Complementarity

Initial historical conditions matter in determining the corporate governance structures that are prevalent today. Current state of a system is determined not only by its initial conditions but also by the path it took (North, 2005). In other words, the evolutionary trajectory of the governance system of a country is the result of several of individual historical events and responses to them. Given that no two countries have the same sets of historical events or similar responses to them, the net result is persistence of existing systems and divergence (Doupnik and Perera, 2009).

Central to the idea of path dependence are complementarities, also called indivisibilities (Schmidt and Spindler, 2000). Complementarity refers to the interdependencies among the different elements of a system. It is based on the idea, that the whole is more than the sum of its parts. In order to appropriate the potential benefits that arise from complementarity, it is indispensable that the elements fit together (Jeffers, 2005). Corporate governance results from a system of complementary institutions, legal rules, and practices where improving any one element independently may actually hurt efficiency (Khanna et al., 2006). Hence, effectiveness of individual governance practices cannot be evaluated in isolation. In other word, corporate law is intimately related not only to social custom but also to other legal areas, such as banking, labor, tax, and competition law that would be hard to change all at once (Guillén, 1999).

4.4. Resistance

The political cost of eliminating international differences is enormous (Doupnik and Perera, 2009). Governance structures can persist even after they have become demonstrably suboptimal because of the presence and actions of parties who resist change, because it would reduce their private benefits of control while the efficiency gains from change would be shared by several actors (Coffee, 1999).

4.5. View of the Firm

The view that prevails in a society on what role business entities are supposed to play, has a distinct impact on the ethics of corporate governance that will reign in that society. In the scholarly discourse on the role of the firm in society a variety of views of the firm are mentioned. Collier and Robberts (2001) distinguished between corporations as a set of ownership rights and corporations as social institutions, Wieland (2005) between the agency theory, the transaction cost theory and the organization theory of the firm, and Kimber, Lipton (2005) between the contractarian and the communitarian view of the firm. Some views of the firm portray firms as vehicles merely for maximizing shareholder value, (e.g. Collier and Roberts's notion of the firm as a set of ownership rights, Wieland's notion of the agency theory of the firm, Kimber and Lipton notion of the contractarian view of the firm). When the view of the firm that dominates thinking about the role of corporations in society prioritizes the interests of shareholders, a shareholder ethic of governance can be expected to be adhered to in that society. If, however, the role of the firm in society is understood differently (for example as social institution, transaction cost and organization theories or communitarian notion), it is likely that a broader stakeholder ethic of governance will prevail (Rossouw, 2009).

The role of a firm in society still needs further examination in light of Shariah. The question of whether a corporation serves the society from its profits or serves solely the interests of its shareholders needs scholarly response. A socially responsible corporation may yield lesser profit to the shareholders and this feature is likely to affect its competitiveness. Without fully resolving such issues, the Islamic financial markets are far from a reality (Ibrahim, 2006).

4.6. Legal Systems

LaPorta et al,. (1997) found that the civil law countries had the weakest investor protections and the least developed markets as compared to common law countries. Consequently, Anglo-Saxon countries have corporate governance codes that focus strongly on protecting the rights of the shareholders. Additionally, law enforcement in common law countries tend to be generally stricter than that of countries with civil law origin such as continental countries and some Islamic countries such as Iran (LaPorta et al., 1997).

4.7. Financers and Ownership Structures

In Insider systems, banks are main financers and in outsider systems, capital markets.

Insider system and some Islamic countries systems such as Iran refer to dispensations where there are strong concentrations of either or both state and family ownership, and where these owners exercise their ownership rights by intervening directly in how the firm is being run. Insider systems rely more on debt than on equity. Minority owners consequently enjoy very little protection and are at the mercy of majority shareholders. In outsider systems, widely dispersed ownership prevails, the interest of both majority and minority shareholders enjoy priority, companies rely on equity rather than debt to finance their operations, and there tends to be an active market. Insider systems favor a more stakeholder orientated corporate governance, whilst outsider systems favor a shareholder orientated corporate governance (Rossouw, 2009). Most Continental European companies are characterized by majority or near-majority stakes held by one or few investors. In contrast, the Anglo-American system is characterized by dispersed equity. (Goergen, Martynova and Renneboog, 2005).

4.8. Economic Development and Type of Business Entities

Different countries economic development level is different. Most European countries are developed and Islamic countries are less. The level of economic development of a country affects the type of business entities that exist in a country. Developed countries are characterized by large and complex conglomerates that often have hundreds of products, employ thousands of people and do business in many countries. In contrast, countries with emerging economies are characterized by small, simple business entities. Corporate governance regulations in each country will reflect the needs of its business entities. In developed economies, they will be detailed and complex since that is what is needed to capture the economic substance of the entities they are corporate governance for. Simpler regulations can suffice for the smaller and less complex business entities typical of developing countries (Saudagaran and Biddle, 1995).

4.9. Lack of Consensus

There is no single model of good corporate governance (OECD, 1999). This is because each model has strengths and weaknesses that may manifest variously in different environments (Jacoby, 2001).

The following table summarizes the following discussion presenting the reasons of divergence.

Table 2

countries	**Islamic (Iran)**	**Anglo-Saxon**	**Continental**
religion	Islam	Generally other than Islam	others
culture	Collectivism More Power distance More uncertainty avoidance Masculinity	Individualism Less Power distance Less uncertainty avoidance Feminism	Collectivism More Power distance more uncertainty avoidance Feminism
Path Dependence and Complementarity	different	different	different
Resistance	more	less	more
View of the Firm	Set of humans rights	Set of shareholders rights	Set of insiders and lenders rights
Legal Systems	Code law	Common law	Code law
Financers and Ownership Structures	Markets and Governments Association of ownership with control Concentrated ownership Non protect God owns all things and humans own no things (they are trustee of god's things)	Capital Markets Separation of ownership from control Dispersed ownership Protect from minority	Banks Association of ownership with control Concentrated ownership Non protect
Economic Development and Type of Business Entities	Developing Small and simple	Developed Large and complex firms	Developed Large and complex firms
Lack of Consensus	lack	lack	lack

5. Conclusion

Recent corporate scandals have further highlighted the importance of corporate governance. Considerable differences exist across countries in the corporate governance mechanisms. Initially, in this study, we familiar with corporate governance models witch exist in the entire world. It is clear that there are differences among Islamic countries and western countries and even among western countries.

Major challenge facing corporate governance globally is convergence of corporate governance. Now, there is some pressure from multinational companies, stock exchange, securities regulators and

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international institutions such as World Bank, to reduce diversity and converge corporate governance regulations internationally. Then, thhis study discusses both drivers and impediments to convergence. Integration of markets, institutional pressure and convergence of accounting standards are drivers of convergence. In contrast, there are several impediments to convergence. They include religion, culture, path dependence and complementarities, resistance by interest groups, view of the firm, financers and ownership patterns, Economic Development and type of business entities, and lack of consensus.

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