The Integrity of Private Third-Party Compliance Monitoring*

*By Jodi L. Short** and Michael W. Toffel****

Government agencies are increasingly turning to private, third-party monitors to inspect and assess regulated entities' compliance with law. Third-party monitors are used to certify compliance with federal standards and other requirements in a wide array of domains, including food safety, pollution control, product safety, medical devices, and financial accounting. For example, third-party monitors assess the compliance of foreign food production facilities with Food and Drug Administration regulations, of children's products with Consumer Product Safety Commission product safety rules, of telecommunication products with Federal Communications Commission regulations, and of registered securities issuers with accounting and internal controls requirements. Several federal agencies rely on third-party monitors to assess adherence to agencies' voluntary product labeling standards, including the Department of Agriculture's National Organic Program, the Environmental Protection Agency (EPA) and Department of Energy's Energy Star Program, and the EPA's WaterSense Program. Many agencies are considering how they might deploy third-party monitoring to enhance their inspection regimes. *See* David Markell & Robert Glicksman, *A Holistic Look at Agency Enforcement*, 93 N.C. L. Rev. 1 (2014).

The integrity of these regulatory regimes rests on the validity of the information third-party monitors provide to regulators. The challenge in designing third-party monitoring regimes is that profit-driven private monitors, typically selected and paid by the firms subject to monitoring, have incentives to downplay problems they observe in order to satisfy and retain their clients. This article discusses the most important factors that can affect the integrity of third-party monitoring and highlights key policy implications for regulators designing third-party monitoring regimes.

Risks to the Integrity of Private Third-Party Monitoring Regimes

Research demonstrates that third-party monitors are strongly influenced by their relationships with the firms they monitor and by economic incentives. A well-designed third-party monitoring program should address several sources of bias shown to influence the likelihood that third-party monitors will accurately and comprehensively identify violations and deficiencies. Below, we focus on five factors associated with auditor leniency.

Finding #1: Third-Party Monitors Tend to Be More Lenient When Monitored Firms Pay Them Directly.

Studies across a range of policy domains have found that third-party monitors face substantial conflicts of interest between attracting and retaining clients and accurately reporting their clients' regulatory compliance. Several studies of pollution-control programs have shown that third-party monitors that exhibit leniency are more likely to retain clients. For instance, when private-sector automobile emissions testing stations conduct smog checks and fail vehicles, those vehicle owners are significantly less likely to continue doing business with those stations. *See, e.g.*, Victor Bennett, Lamar Pierce, Jason Snyder, & Michael Toffel, *Customer-Driven Misconduct: How Competition Corrupts Business Practices*, 59 Mgmt. Sci. 1725 (2013).

An analysis of a pollution-control program that required regulated firms to submit annual pollution readings taken by third-party monitors found that monitors selected and paid by monitored firms frequently reported false pollution readings to regulators. *See* Esther Duflo, Michael Greenstone, Rohini Pande & Nicholas Ryan, *Truth-Telling by Third-Party Auditors and the Response of Polluting Firms: Experimental Evidence from India*, 128 Q. J. Econ. 1499 (2013). In contrast, these monitors reported substantially higher pollution levels, verified to be more accurate in follow-up inspections by regulators, once monitored firms were no longer allowed to select and pay their own auditors, but instead were required to pay into a central government fund that, in turn, assigned and paid the monitors. Similarly, a study of social auditors monitoring supply chains on behalf of global brands concluded that these third-party monitors find and cite fewer violations when they are paid by the audited suppliers than when they are paid by the brand. *See* Jodi Short, Michael Toffel, & Andrea Hugill, *Monitoring Global Supply Chains*, 37 Strategic Management Journal 1878 (2016).

Research has likewise demonstrated that conflicts of interest arising from client payment arrangements shade the assessments of third-party monitors in financial regulation. Several studies have found that credit rating agencies, whose ratings are relied upon by

* A version of this article that includes references to all mentioned studies is available at http://ssrn.com/abstract=2695429. The authors thank Garrett Smith, UC Hastings College of the Law (J.D. 2017), for invaluable research assistance on this project.

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investors and regulators to assess the risks associated with certain securities, issue more favorable ratings when they are paid by the issuers of those securities rather than by investors. *See, e.g.,* John Jiang, Mary Harris Stanford, & Yuan Xie, *Does it Matter Who Pays for Bond Ratings? Historical Evidence*, 105 J. Fin. Econ. 607 (2012). There is also evidence that stock analysts rate stocks more favorably when they receive commissions from the issuers or traders of those securities. Tellingly, research has shown that these third-party financial monitors exhibit more bias when more money is at stake: the less important the client is to the monitor's bottom line, the more accurate the monitor's assessment. *See* Matthias Efing & Harald Hau, *Structured Debt Ratings: Evidence on Conflicts of Interest*, 116 J. Fin. Econ. 46 (2015).

Finding #2: Third-Party Monitors Tend to Be More Lenient When Monitoring Firms That Are Prospective Customers for the Monitor's Non-Audit Product Lines.

In addition to the direct conflicts of interest created when monitors are selected and paid by monitored entities, research documents erosion in monitoring integrity due to indirect economic incentives created by monitors' desire to pursue other types of business opportunities with monitored entities. For example, private smog check facilities in New York State that faced profitable opportunities to sell other services to car owners (that is, to "cross-sell") were more likely to falsely pass cars that did not meet emissions standards than did facilities that did not have such opportunities. *See* Lamar Pierce & Michael Toffel, *The Role of Organizational Scope and Governance in Strengthening Private Monitoring*, 24 Org. Sci. 1558 (2013). Similarly, other studies have shown that executive compensation consultants recommend higher executive salaries when those consultants offered other services of interest to those executives. Also, when European banks began cross-selling financial services unrelated to loans, they lowered their loan screening criteria and began rating potential borrowers more favorably to attract more customers. Several recent studies likewise find that under many conditions, lenient financial auditing is associated with accountants' ability to earn fees for non-audit services from the client. *See, e.g.,* Monika Causholli, Dennis Chambers, & Jeff Payne, *Future Nonaudit Service Fees and Audit Quality*, 31 Contemp. Acct. Res. 681 (2014).

Finding #3: Third-Party Monitors Tend to Be More Lenient When They Face More Competition.

Competition forces monitors to differentiate themselves to capture market share. Research has shown that one way third-party monitors compete for business from those seeking audits is by exhibiting greater leniency. For instance, smog check stations that faced more local competition were more likely to falsely pass cars than stations facing fewer competitors. *See* Bennett *et al.*, *supra*. Studies have similarly shown that the quality of credit ratings has declined in markets where credit rating agencies face more competition, and that financial statement auditing quality is worse when accountants operate in more competitive markets. Many studies have observed that competition among monitors allows audited firms to opinion shop for more favorable results. *See, e.g.,* Nathan Newton, Julie Persellin, Dechun Wang, & Michael Wilkins, *Internal Control Opinion Shopping and Audit Market Competition*, 91 Acct. Rev. 603 (2016).

Finding #4: Third-Party Monitors Tend to Be More Lenient When Monitoring Firms with Whom They Have Longstanding Relationships.

Experimental research has demonstrated that cognitive biases and social pressures dissuaded monitors from reporting wrongdoing at firms with whom they have longstanding relationships, and some archival studies have suggested that monitors' familiarity with the firms they audit can embolden managers at those firms to pressure or bribe monitors to report good results. *See, e.g.*, Bryan Church, J. Gregory Jenkins, Susan McCracken, Pamela Roush, & Jonathan Stanley, *Auditor Independence in Fact: Research, Regulatory, and Practice Implications Drawn from Experimental and Archival Research*, 29 Acct. Horizons 217 (2015); Fahad Khalil & Jacques Lawarrée, *Incentives for Corruptible Auditors in the Absence of Commitment*, 54 J. Indust. Econ. 269 (2006). Recent research confirms that cozy relationships with clients can compromise the integrity of audit results, finding that supply chain monitors detect and report fewer violations at entities they have previously audited. *See* Short *et al.*, *supra*. Research on credit rating agencies documents similar biases arising out of close relationships with the firms they monitor. Credit rating analysts have been shown to become more optimistic and less accurate after rating a firm for three years. Another study demonstrates that credit ratings agencies' "ratings teams," which interact directly with clients, are less accurate in evaluating offerings than their "surveillance teams," which do not interact directly with clients. John M. Griffin & Dragon Youngjun Tang, *Did Credit Rating Agencies Make Unbiased Assumptions on CDOs?* 101 Amer. Econ. Rev. 125 (2011). Similar concerns have been found regarding longstanding relationships between regulated entities and individual government inspectors. *See* Jeffrey Macher, John Mayo, & Jack Nickerson, *Regulator Heterogeneity and Endogenous Efforts to Close the Information Asymmetry Gap: Evidence from FDA Regulation*, 54 J.L. & Econ. 25 (2011).

Finding #5: Third-Party Monitors with Less Training Tend to Be More Lenient.

Research suggests that the integrity and validity of audit findings can be enhanced by training monitors to conduct third-party assessments. For instance, a study of third-party supply chain monitors found that, despite other potential biases, monitors are more effective when they receive more training in how to detect

violations. *See* Short *et al.*, *supra*. More highly trained inspectors and auditors have also been found to conduct more rigorous food safety inspections and to produce more accurate financial audits and credit ratings. *See, e.g.*, Timothy Lytton & Lesley McAllister, *Oversight in Private Food Safety Auditing: Addressing Auditor Conflict of Interest*, 2014 Wis. L. Rev. 289.

Policy Implications

This body of research suggests a number of policy implications for regulators seeking to bolster the validity of third-party monitoring regimes.

Policy Implication #1: Third-Party Monitoring Bias Can Be Mitigated by Policies That Prevent Monitors from Being Paid Directly by or Selected by Monitored Firms.

For instance, qualified monitors could be assigned by regulators or at random rather than be selected by monitored firms, and could be paid through a common fund to which all monitored entities would be required to contribute. Such policy innovations have been shown to substantially enhance the accuracy of environmental audits. *See* Duflo *et al.*, *supra*.

Policy Implication #2: Third-Party Monitoring Bias Can Be Mitigated by Policies That Limit Monitors' Cross Selling of Other Services to the Entities They Monitor.

The Sarbanes-Oxley Act, for instance, substantially restricts financial auditors' ability to sell non-audit accounting and consulting services to their audit clients. Pub. L. No. 107-204, § 201. In structuring their vehicle tailpipe emissions testing markets, several states and Washington D.C. require that vehicle inspections be conducted at testing-only providers. Similarly, EPA regulations prohibit test laboratories from selling both design services and testing/certification services to wood stove manufacturers within a five-year period. *See* 40 C.F.R. § 60.535(a)(2)(vi) (2015).

Policy Implication #3: Third-Party Monitoring Bias Associated with Longstanding Auditing Relationships Can Be Mitigated by Policies Requiring Term Limits on Client–Monitor Relationships.

Concerns arising out of longstanding monitor–client relationships can be addressed through rotation requirements, which impose term limits that require clients to change third-party monitors periodically to reduce the cognitive constraints and relational incentives that can bias their assessments. For instance, the European Union recently passed audit reform policies that will require public companies, banks, and insurance companies to change their financial auditors at least every ten years, following a similar proposal by the U.S. Public Company Accounting Oversight Board (PCAOB), *see Concept Release on Auditor Independence and Audit Firm Rotation*, Release No. 2011–006 (2011). California's greenhouse gas emissions verification program adopts a different approach to address the potential for bias in longstanding relationships between third-party monitors and their clients. Although it does not mandate monitor rotation, it requires firms that have been audited by the same monitor for more than five years to submit a conflict-of-interest mitigation plan to the regulator for approval. *See* Cal. Code of Reg., Title 17, §95979.

Policy Implication #4: Third-Party Monitoring Bias Can Be Mitigated by Requirements That Auditors Receive Training Designed to Promote Objectivity, Competency, and Consistency.

Regulators may be able to mitigate bias and enhance the validity of third-party monitoring regimes by requiring that monitors meet specified training requirements. Regulators can also promote monitor competence and professionalism by requiring that monitors be accredited by internationally recognized standard-setting bodies. For example, the International Organization for Standardization (ISO) relies on a network of national accreditation bodies to ensure that third-party monitors certifying adherence to its environmental and quality management system standards are sufficiently trained. Along the same lines, the Food and Drug Administration recently adopted a rule requiring that food safety auditors be accredited through an agency-approved process. *See* Accreditation of Third-Party Certification Bodies to Conduct Food Safety Audits and to Issue Certifications, 80 Fed. Reg. 74569 (adopted Jan. 27, 2015).

Policy Implication #5: Third-Party Monitoring Bias Can Be Mitigated by Policies That Build Redundancy into Monitoring Regimes.

The accuracy of third-party monitors' assessments has been shown to increase when different monitors, who have different sets of interests and incentives, independently monitor the same firms. *See* Alexander Ljungqvist, Felicia Marston, Laura Starks, Kelsey Wei, & Hong Yan, *Conflicts of Interest in Sell-Side Research and the Moderating Role of Institutional Investors*, 85 J. Fin. Econ. 420 (2007). Thus, a monitoring regime that incorporates spot checks against which monitors' results can be compared is likely to encourage greater accuracy. Some regulators also directly monitor the processes and performance of their third-party monitors. The PCAOB, for instance, annually inspects large accounting firms and reports defects to those firms, which must remedy them or face public disclosure of the defect report. Sarbanes-Oxley Act, Pub. L. No. 107-204, § 104(g)(2).

Policy Implication #6: Third-Party Monitoring Bias Can Be Mitigated by Policies That Require Transparency in Monitoring Regimes.

Disclosure of information about various aspects of the monitoring process, including monitor selection and monitoring results, can also enhance the integrity of third-party

inspection regimes. For instance, disclosures about the financial arrangements monitors have with monitored firms, including both audit and non-audit fees, may be useful in identifying and mitigating biases that can arise from these arrangements. Moreover, requiring third-party monitors to submit their findings directly to the regulator, without advance review (even informally) by the monitored firm, could enhance the validity of monitoring by reducing opportunities for monitored firms to pressure monitors to soften their findings.

In addition, regulators may be able to promote greater accuracy by disclosing information about auditor performance. Publicly recognizing and rewarding monitors for their accuracy has been shown to prompt monitors to be more accurate going forward in order to maintain their reputations and the resulting benefits they receive from the accolade. *See* Lily Fang & Ayako Yasuda, *The Effectiveness of Reputation as a Disciplinary Mechanism in Sell-Side Research*, 22 Rev. of Fin. Stud. 3735 (2009). Policy makers could publish similar lists across a wide array of monitoring domains.

Policy Implication #7: Monitoring Bias Can Be Mitigated by Policies That Impose Liability in Monitoring Regimes.

Another way to mitigate monitoring bias resulting from the incentives associated with business relationships is to create a set of countervailing incentives encouraging monitor independence. In Australia, for example, credit rating agencies can be held liable for basing their ratings on faulty assumptions and not altering ratings after discovering errors upon which they were issued. Some regulatory regimes and common law doctrines impose legal liability on third-party monitors for failing to identify and report legal violations at the firms they monitor. For example, the New York State Department of Financial Services has levied sanctions against financial auditors who improperly modified reports submitted to regulators after appeasing client requests to remove potentially damaging findings. Financial auditors can face sanctions under the Sarbanes-Oxley Act for failing to properly identify and correct accounting problems at audited firms. Food safety auditors have faced negligence suits for certifying the compliance of food producers whose products caused foodborne illnesses. *See* Lytton & McAllister, *supra*.

Conclusion

A growing body of research examines factors that risk undermining the integrity of private, third-party monitors that are inspecting and assessing entities' compliance with laws, regulations, standards, and other rules. This article highlights a number of opportunities for policy makers to better ensure that third-party monitors are themselves properly monitored to bolster the accuracy of their assessments of a wide range of regulated activities.

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