



The Integrity of Private Third-Party Compliance Monitoring

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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. Third-party monitors assess the compliance of foreign food production facilities with US Food and Drug Administration regulations, of children's products with Consumer Product Safety Commission product safety rules, and of telecommunication products with Federal Communications Commission regulations.¹ Many states rely on third-party monitors to assess vehicle tailpipe emissions to ensure compliance with US Environmental Protection Agency standards.

Several federal agencies also rely on third-party monitors to assess adherence to agencies' voluntary standards that govern product labels, including the US Department of Agriculture's National Organic Program, the US Environmental Protection Agency and Department of Energy's Energy Star Program, and the US Environmental Protection Agency's WaterSense Program.²

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 paper discusses the most important factors that our research and the research of many others has shown can affect the integrity of third-party monitoring, and highlights some 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 the following documented sources of bias that have been shown to influence the likelihood that third-party monitors will accurately and comprehensively identify violations and deficiencies. 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.³

In an analysis of a pollution control program that required regulated firms to submit annual pollution readings taken by third-party monitors, researchers found that monitors selected and paid by monitored firms frequently reported false pollution readings to regulators.⁴ In contrast, these monitors reported substantially higher pollution levels, verified in follow-up inspections to be more accurate, after the regulator altered the certification regime to prevent firms from choosing and paying their own monitoring firms, instead requiring them to pay into a central government fund that both assigned monitors and paid them. Similarly, a study of social auditors

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monitoring supply chains on behalf of global brands concluded that these monitors find and cite fewer violations when they are paid by the audited suppliers than when they are paid by the brand.⁵

Research has likewise demonstrated that conflicts of interest arising from client payment arrangements shade the assessments of third-party monitors in financial regulation. Credit rating agencies, whose ratings are relied upon by investors and regulators to assess the risks associated with certain securities, started issuing significantly more favorable ratings once the rating agencies began being paid by the issuers of those securities.⁶ There is also evidence that stock analysts rate stocks more favorably when they receive commissions from the issuers or traders of those securities.⁷ Tellingly, studies have shown that these third-party financial monitors exhibit more bias when more money is at stake (in the form of fees or other revenue streams from the client); the less important the client is to the monitor's bottom line, the more accurate the monitor's assessment.⁸

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.⁹ Similarly, executive compensation consultants recommend higher executive salaries when they offered other services that those same executives might be enticed to purchase.¹⁰ 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.¹¹ 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.¹²

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 by 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.¹³ Studies have similarly shown that the quality of credit ratings has declined in markets where credit rating agencies face more competition.¹⁴ Financial statement auditing quality is also worse when accountants operate in more competitive markets.¹⁵ Many studies have observed that competition among monitors allows audited firms to opinion shop for more favorable results.¹⁶

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 which they have longstanding relationships.¹⁷ Other 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.¹⁸ Our interviews with managers at third-party monitoring firms indicate that they are concerned about the risk of their staff empathizing with the firms they monitor, compromising their independence. Recent research confirms that cozy relationships with clients can compromise the integrity of audit results, reporting for instance that supply chain monitors find and report fewer violations at entities they have previously audited.¹⁹ 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.²⁰ 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.²¹ Similar concerns have been raised regarding longstanding relationships between regulated entities and individual government inspectors.²²

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.²³ Highly trained third-party monitors also conduct more rigorous food safety audits.²⁴ Similarly, accountants with relevant expertise²⁵ and credit rating analysts with graduate-level business training were more accurate than those without.²⁶

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.²⁷

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.²⁸ In structuring their vehicle tailpipe emissions testing markets, several states—including Arizona, Colorado, Delaware, Illinois, Indiana, Oregon, and Tennessee—and Washington DC avoid the risk that incentives to cross-sell maintenance and repair services might affect the stringency of vehicle emissions testing by requiring that vehicle inspections be conducted at testing-only providers. Similarly, US Environmental Protection Agency regulations prohibit test laboratories from selling both design services and testing/certification services to wood stove manufacturers within a five-year period.²⁹

Policy Implication #3. Third-party monitoring bias prompted by competition can be mitigated by policies designed to ameliorate the negative incentives created by competition. Regulators should be cognizant that while strong competition among third-party monitors for market share, like other types of economic incentives, can impact the quality and validity of monitoring, monopolies or oligopolies in monitoring markets may also cause unwanted distortions. Thus, in markets where concerns about competition exist, regulators could focus on mitigating the bias associated with economic incentives by implementing policies like the others discussed in this section to bolster third-party monitors' competence and independence.

Policy Implication #4. 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 avoid or reduce the cognitive constraints and relational incentives that can bias their assessments.³⁰ 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,³¹ following a similar proposal by the US Public Company Accounting Oversight Board (PCAOB) in 2011.³² 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.³³

Policy Implication #5: 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. Such policy mandates may be especially warranted in markets where monitors seek to avoid incurring training costs and monitored firms seek to avoid

additional violations being detected by more highly trained monitors. Regulators can also promote monitor competence and professionalism by requiring that monitors be accredited by internationally recognized standard-setting bodies. For example, third-party monitors certify that firms are adhering to the ISO 9001 Quality Management System Standard, and the International Organization for Standardization (ISO) relies on a network of national accreditation bodies to ensure that the monitoring staff is sufficiently trained. Along the same lines, the Food and Drug Administration has proposed a rule requiring that food safety auditors be accredited by an agency-approved organization.³⁴

Policy Implication #6: 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.³⁵ 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.³⁶

Policy Implication #7: 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.³⁷ Policy makers could publish similar lists across a wide array of monitoring domains.

Policy implication #8: 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 rating after discovering errors upon which they were issued.³⁸ 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.³⁹ 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.⁴⁰ 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.⁴¹

Conclusion

A growing body of research is examining 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 paper 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.

Endnotes

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