GRAY MATTER

See Red Flags, Hear Red Flags

By Michael Greenstone

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WHAT do Enron and the corporate-accounting scandals of the early 2000s have in common with the subprime-mortgage crisis and the Great Recession? In both cases, the delivery of accurate information to the broader economy was compromised because auditors were hired and paid by the firms they audited.

Auditors face a conflict of interest between reporting the truth and running their businesses successfully. Our economy and many markets throughout the world remain vulnerable to this conflict. But it does not have to be this way.

There have been efforts to strengthen auditing regulations. In the early 2000s, Congress created a watchdog organization, the Public Company Accounting Oversight Board, to reduce the chances of accounting scandals. But the board's work to implement even modest reforms has faced strenuous opposition from the auditing profession.

Senator Al Franken's amendment to the Dodd-Frank financial-reform law of 2010 targeted an obvious conflict of interest — security issuers shopped for their own ratings, which contributed to credit rating agencies' generous grading of many financial products before the Great Recession. Despite bipartisan support for the amendment, lawmakers instead asked the Securities and Exchange Commission to study the issue. Three years later, they're still studying.

What would happen if auditors were given better incentives to tell the truth?

In a recent study published in The Quarterly Journal of Economics, my co-authors — Esther Duflo, of M.I.T., and Rohini Pande and Nicholas Ryan, both of Harvard — and I reported on an experiment we conducted in the state of Gujarat, India. We found that altering auditors' incentives to mitigate the conflict of interest leads auditors to report more truthfully. More important, this means regulations work better and keep people safer.

We focused on the regulation of air and water pollution from industrial plants in Gujarat. The Gujarat Pollution Control Board (G.P.C.B.) requires plants with high pollution potential to hire and pay auditors to check air and water pollution levels three times annually and then submit a yearly report to the G.P.C.B.

With the G.P.C.B., we changed the auditing rules for a randomly selected set of firms, but not for a control group. The randomized selection is important because it ensures that the firms required to comply with the new auditing rules are initially no different from the control firms.

Olimpia Zagnoli

In the new system, auditors were paid a fixed fee from a central pool of money, a subset of the audits was chosen to have its findings re-examined, and auditors received payments for accurate reports, judged by comparisons with the re-examinations. The control group continued under the status quo system in which auditors were chosen and paid by the plants they were auditing.

The results are striking. While many of the plants violated the pollution standards, few of the auditors in the control group reported these violations. In the case of particulate matter, an especially harmful air pollutant, auditors reported that only 7 percent of industrial plants violated the pollution standard. In reality, 59 percent of plants exceeded it.

The rules changes caused the auditors to report more truthfully. In the restructured market, auditors were 80 percent less likely to falsely report a pollution reading as in compliance, and their reported pollution readings were 50 to 70 percent higher than when they were working in the status quo system. This difference was as large even when comparing reports of auditors working simultaneously under the two systems.

Finally, and most important, the plants that were required to use the new auditing system significantly reduced their emissions of air and water pollution, relative to the plants operating in the status quo system. Presumably, this was because the plants' operators understood that the regulators were receiving more accurate information and would follow up on it.

The regulation of pollution in Gujarat differs from requirements for quarterly financial reports and the rating of bonds in several respects. However, like all third-party audit markets, they share a common conflict of interest: The auditors are hired and paid by the firms who have a stake in the outcome of the audit.

This example shows that common-sense changes in incentives allow auditors to report more accurately and regulations to work. But reforms that fail to target the fundamental conflict of interest are unlikely to succeed.

A criticism of such reforms is that they would be too costly. But the opposite is more likely. That's because when people own stocks or buy bonds, they're taking a risk because they don't know everything about the company or bond they're investing in, and prices reflect that risk. The more they know, the lower the risk, and the higher the stock and bond prices, ultimately producing a more efficient and fairer financial system.

Altering the third-party auditing system isn’t the solution to all our economic problems. But removing the fundamental conflict of interest behind the auditing of public firms and the rating of financial products is likely to help prevent some future ones.

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