

MONITORING GLOBAL SUPPLY CHAINS

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Research summary: Firms seeking to avoid reputational spillovers that can arise from dangerous, illegal, and unethical behavior at supply chain factories are increasingly relying on private social auditors to provide strategic information about suppliers' conduct. But little is known about what influences auditors' ability to identify and report problems. Our analysis of nearly 17,000 supplier audits reveals that auditors report fewer violations when individual auditors have audited the factory before, when audit teams are less experienced or less trained, when audit teams are all male, and when audits are paid for by the audited supplier. This first comprehensive and systematic analysis of supply chain monitoring identifies previously overlooked transaction costs and suggests strategies to develop governance structures to mitigate reputational risks by reducing information asymmetries in supply chains.

Managerial summary: Firms reliant on supply chains to manufacture their goods risk reputational harm if the working conditions in those factories are revealed to be dangerous, illegal, or otherwise problematic. While firms are increasingly relying on private-sector "social auditors" to assess factory conditions, little has been known about the accuracy of those assessments. We analyzed nearly 17,000 code-of-conduct audits conducted at nearly 6,000 suppliers around the world. We found that audits yield fewer violations when the audit team has been at that particular supplier before, when audit teams are less experienced or less trained, when audit teams are all male, and when the audits were paid for by the supplier instead of by the buyer. We describe implications for firms relying on social auditors and for auditing firms. Copyright © 2015 John Wiley & Sons, Ltd.

INTRODUCTION

Reputation is a key strategic concern for modern firms (Roberts and Dowling, 2002) and environmental, social, and governance (ESG) performance has become an increasingly important dimension of firm reputation. Poor ESG practices may make firms targets for activists, harming their reputations as well as their bottom lines (King and Soule, 2007), and firms are increasingly held accountable

by financial analysts and investors for ESG performance (Ioannou, 2014). Furthermore, firms that mislead stakeholders about their ESG performance through inaccurate disclosures may find their reputations tarnished (Fombrun, Gardberg, and Barnett, 2000).

As firms continue to outsource production globally, their reputations have come to depend not solely on their own practices but also on those of the companies in their extended supply chains (Heide, Kumar, and Wathne, 2014), bringing the risk of reputational spillover costs from these transactions. That risk is particularly high when production is outsourced to countries where labor and environmental standards are so low that suppliers commonly take "unwarranted risks in their project

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execution . . . that the outsourcing principal would never tolerate if it kept control of the activity” (Geis, 2007: 979). For instance, when the Rana Plaza building collapsed in Bangladesh, killing 1,100 factory workers, the bulk of media, consumer, and activist scrutiny focused not on the suppliers who used the building but on the global retailers that sourced from them (Greenhouse, 2013a). Many of these global retailers were under such intense reputational pressure that they agreed to adopt a legally binding agreement to spend hundreds of millions of dollars to fund fire-safety and structural improvements in the factories of their Bangladeshi suppliers (Greenhouse, 2013b).

The logic of transaction cost economics (TCE) predicts that firms will vertically integrate activities that pose substantial risks to their reputations so that they have more control over execution (Mayer, 2006; Mayer, Nickerson, and Owan, 2004; Nickerson and Silverman, 2003). However, because the potential production-cost economies of global outsourcing are so significant, most firms continue to contract out to risky suppliers and have sought to contain reputational spillover costs through intensive supplier monitoring programs that contractually impose ESG standards and compliance inspections (Gereffi, Humphrey, and Sturgeon, 2005; Mayer *et al.*, 2004; Montiel, Husted, and Christmann, 2012).

Supplier monitoring is a transactional governance mechanism designed to provide buyer firms with information that can help them manage supply chain risk and make strategic outsourcing decisions. However, it is not clear that buyer firms are getting complete and accurate information from their supply chain monitors (e.g., Esbenshade, 2004; Heras-Saizarbitoria and Boiral, 2013; O’Rourke, 2002). For instance, in 2012, just weeks after social auditors certified that a factory in Pakistan met the SA8000 working conditions standard created by a respected nonprofit, a fire there killed hundreds of workers, some of whom were trapped by locked emergency exits and barred windows—clear violations of that very standard (Walsh and Greenhouse, 2012). When monitors fail to accurately assess suppliers’ adherence to standards, they undermine buyer firms’ ability to make fully informed outsourcing decisions and subject these firms to the risk of catastrophic reputational consequences.

Despite the importance of supply chain monitors to firms’ governance of reputational risk, little is known about how such monitors do their jobs or the

validity of the information obtained through their inspections (Mayer *et al.*, 2004). To our knowledge, no empirical research has rigorously investigated what factors shape supply chain monitors’ assessments of supplier adherence to standards. We seek to fill that gap. Grounding our work in the transaction cost economics literature and drawing insights from research on regulatory compliance, financial auditing, and bounded rationality, we argue that monitors are not merely objective conduits of information, but instead that the information they collect and transmit is shaped by a variety of social relationships, institutions, and identities. This has important implications for outsourcing firms, because heterogeneity in auditor assessment may undermine the efficacy of the governance structures they have put into place to contain the costs of reputational spillovers.

We test our hypotheses in the context of social auditing for compliance with labor standards contained in contractually imposed supplier codes of conduct. This form of private supply chain monitoring has been adopted by thousands of prominent multinational corporations (MNCs), including all U.S. *Fortune* 500 companies (McBarnet, 2007), yet to our knowledge it has not been addressed in the TCE literature. We exploit a novel dataset drawn from thousands of audits for code-of-conduct compliance conducted in 66 countries by one of the world’s largest supply chain auditing firms. We find that auditors’ decisions are shaped by factors such as ongoing client relationships, professional experience, gender, and gender diversity. Specifically, supplier audits yield fewer violations when conducted by audit teams that include individual auditors who have audited that supplier before, when audit teams have less auditing experience and less in-house audit-skills training, and when audit teams consist only of male auditors. Audits also yield fewer violations when the audits are paid for by the supplier as opposed to the buyer. These findings significantly broaden the prevailing understanding of the supply chain monitoring process and suggest ways to design more effective monitoring regimes.

LITERATURE REVIEW

Decisions about outsourcing and supply chain management have become increasingly critical strategic concerns (Alcacer and Oxley, 2014; Hult, Ketchen, and Arrfelt, 2007; Reitzig and

Wagner, 2010). Current concerns go beyond the paradigmatic “make or buy” dilemma (Williamson, 1975) to complex strategic questions about *which suppliers to buy from*. Choosing wisely can enhance a firm’s value by, for instance, improving its financial performance (Doig *et al.*, 2001) or providing opportunities to develop knowledge (Alcacer and Oxley, 2014; Hult *et al.*, 2007). On the other hand, poor choices can subject firms to significant costs, including remediation, legal liability, and reputational damage (O’Callaghan, 2007).

To reduce the reputational risks of outsourcing and to protect brand value, firms incur significant transaction costs to monitor supplier behavior. As a condition of doing business, most MNCs require suppliers to meet globally recognized standards in areas including environmental sustainability, working conditions, and human rights (McBarnet, 2007), and many employ supply chain auditors to monitor adherence to these standards (Montiel *et al.*, 2012). The TCE literature has long theorized that monitoring is a key governance mechanism for reducing transaction costs resulting from business partners’ opportunistic exploitation of information asymmetries (Eisenhardt, 1985; Heide *et al.*, 2014). Studies have found that stringent monitoring is particularly important when opportunism by one party threatens to impose reputational spillover costs on the other (Mayer *et al.*, 2004). In theory, monitoring constrains opportunism and mitigates spillover costs by reducing information asymmetry (Heide, Wathne, and Rokkan, 2007). The theory assumes, however, that the information firms obtain from their monitors is accurate and complete.

This may not always be the case. First, just as bounded rationality constrains transacting parties’ ability to foresee and plan for contingencies that might arise over the course of a business relationship, it is also likely to constrain monitors’ ability to identify and communicate information about supply chain conditions. Second, many firms that have outsourced production to global supply chain partners have likewise outsourced the monitoring of those transactions to private, third-party social auditors. This additional layer of contractual relationships introduces the potential for agency problems into monitoring structures, because third-party monitors’ incentives may not always be aligned with the buyer firm’s incentives (Khalil and Lawarrée, 2006). Indeed, research has demonstrated that private, third-party monitors are more lax in enforcing the rules imposed by their principal when a stringent

approach could undermine their own opportunities for profit (Montiel *et al.*, 2012; Pierce and Toffel, 2013). Consequently, firms that have outsourced the governance of their outsourced transactions must also consider how to monitor their monitors.

Despite monitoring’s central role in reducing transaction costs, TCE and supply chain standards research has shed little light on how it works in practice and what factors contribute to the generation of reliable information (Mayer *et al.*, 2004). TCE studies of monitoring have tended to focus on “ex ante safeguards to deter ex post opportunism” (Williamson, 2008: 6) and facilitate monitoring, including contractual provisions (e.g., Argyres, Bercovitz, and Mayer, 2007; Barthélemy and Quélin, 2006), technological capabilities (Mayer and Salomon, 2006), and a shared knowledge base (Heide *et al.*, 2014). Only a few studies investigate how this governance structure is put into practice and, to our knowledge, none addresses factors associated with the reliability of information obtained through monitoring. Mayer *et al.* (2004), for instance, find that firms are more likely to inspect suppliers’ plants, production processes, and physical output when there is a substantial risk of reputational spillover. Handley and Gray (2013) establish through survey data that suppliers subjected to more frequent quality monitoring are more likely to perceive that the buyer has expectations of high quality.

The most extensive analysis of private supply chain standards has been in the organizational and operations literatures, which document how these standards are developed (Wood, 2004), why they are adopted (e.g., Delmas and Toffel, 2008; Short and Toffel, 2008; Terlaak and King, 2006), and their financial, operational, and compliance outcomes (e.g., Esbenschade, 2004; King and Lenox, 2001; Kocer and Fransen, 2009; Levine and Toffel, 2010; Locke, Rissing, and Pal, 2013; Potoski and Prakash, 2005; Rodríguez-Garavito, 2005; Short and Toffel, 2010; Terlaak and King, 2006; Toffel and Short, 2011). This extensive body of research tacitly assumes a pivotal role for private auditors, but provides little insight into how they play that role (Heras-Saizarbitoria and Boiral, 2013).

A few empirical studies have investigated influences on private-sector auditor performance, but have focused almost exclusively on economic conflicts of interest. For example, research finds that auditors are more lax when monitoring their own paying clients (e.g., Duflo *et al.*, 2013; Jiang, Stanford, and Xie, 2012; Kinney, Palmrose, and

Scholz, 2004), facing more competition (Bennett *et al.*, 2013), enjoying lucrative cross-selling opportunities (Pierce and Toffel, 2013), or operating in corrupt environments in which they are more likely to receive side payments from audited firms (Montiel *et al.*, 2012). Based on such findings, the literature has assumed that profit is the private auditor's dominant, if not exclusive, motive (Bazerman, Morgan, and Loewenstein, 1997; Moore *et al.*, 2006; Partnoy, 2006).

While it is crucial to understand how conflicts of interest affect the quality of information generated through monitoring, our study seeks to move beyond economic incentives to investigate how social institutions and relationships shape and constrain the performance of monitoring functions. These influences are well established in related literatures, but they have yet to shed light on how monitoring functions as a governance structure supporting outsourced production. TCE's foundational assumption is that transacting parties are constrained by bounded rationality (Williamson, 1979), but it has failed to consider how bounded rationality likewise constrains those who do the monitoring. Research on public regulatory implementation suggests that *government* monitors are constrained by bounded rationality. For instance, studies document significant heterogeneity in the way government inspectors apply the rules they are charged with enforcing (Feinstein, 1989; Hawkins, 1984; Lemley and Sampat, 2012; Macher, Mayo, and Nickerson, 2011), based on a variety of social factors (Lipsky, 1980/2010; Piore, 2005; Schrank, 2009). Experimental studies in social psychology similarly reveal the influence of cognitive biases on the performance of financial auditors (e.g., Asare, Trompeter, and Wright, 2000; Tetlock, 1983). But these insights have not been tested in the context of private supply chain monitoring. We draw on these literatures to develop hypotheses about the factors influencing private supply chain auditors and to illuminate how firms can structure governance arrangements to maximize the reliability of the strategic information they receive about their suppliers through monitoring.

HYPOTHESES

Ongoing auditor–supplier relationships

The primary function of transactional governance structures is to limit or “economiz[e] on bounded

rationality while simultaneously safeguarding the transactions in question against the hazards of opportunism” (Williamson, 1979: 245–6). However, the implementation of governance structures is itself constrained by bounded rationality and thus subject to opportunism. Many have theorized that the performance of monitors who repeatedly inspect a firm is likely to be shaped by cognitive biases and social pressures that influence the monitors' detection and citing of violations. Bounded rationality limits the number of issues an auditor can pursue during any given audit (Jones, 2001; Simon, 1947). As Chugh and Bazerman (2007: 3) have argued, “bounded awareness” causes individuals to “overfocus on some information and fail to use other easily available information.” Specifically, people tend to focus on information that comports with the tacit knowledge they have gained through experience. Though tacit knowledge can be a useful resource for decision makers, “dependence on tacit knowledge can create bounds on their awareness” (Kumar and Chakrabarti, 2012: 940) that limit their ability to perceive new issues.

These cognitive constraints are likely to be reinforced by social pressures and opportunism. Returning auditors may develop “cozy relationships” (Moore *et al.*, 2006: 24) with an audited firm's management that lead them to identify with and support its positions. In some circumstances, these relationships may go from cozy to corrupt if familiarity between auditors and management emboldens managers to pressure or even bribe auditors to report good results (Khalil and Lawarrée, 2006; Montiel *et al.*, 2012).

Empirical research has found that managers' awareness is bounded by experience. “Managers use already established knowledge to determine what they see, and they use what they already know to choose what to look for in their environment” (von Krogh, Roos, and Slocum, 1994: 58); such “perceptual and cognitive limitations” lead to errors (Huber and Power, 1985: 172). Empirical research has found that ongoing relationships between government inspectors and inspected entities encourage a “benefit of the doubt” style of enforcement rather than an arms-length “policing” style (Bardach and Kagan, 1982/2002), resulting in milder penalties (Muehlenbachs, Staubli, and Cohen, 2013). We argue that private supply chain auditors will be subject to similar social pressures and cognitive constraints. If they repeatedly inspect the same supplier, they are more likely to focus on the domains they

highlighted previously and to align their perspectives with that of management, whereas a new audit team would bring a fresh set of eyes and focus on different issues, likely uncovering new violations. We therefore hypothesize:

Hypothesis 1 (H1): An audit will yield fewer violations when conducted by an audit team that includes a member of the supplier's previous audit team.

Auditor tenure

Rationality can be bounded not only by cognitive constraints, but also by social structures, identities, and socialization (March and Olsen, 1998; Simon, 1947). Auditors' tenure on the job is associated with their level of professional knowledge, their place in the audit firm's organizational hierarchy, and their professional self-concept. Scholars and activists have argued that more experienced supply chain auditors are more effective (Esbenshade, 2004; Locke, Qin, and Brause, 2007). It is not clear, however, how experience affects the number of violations cited in a given audit. On the one hand, experience enhances auditors' practical knowledge and thus their ability to identify violations, as has been documented in qualitative studies of government inspectors (Bardach and Kagan, 1982/2002). Our interviews with managers of social auditors indicate that experience acquaints auditors with "tricks of the trade" such as how to detect that a supplier uses child labor even if child workers are not present during the audit.

On the other hand, these initial marginal detection gains from experience tend to diminish over time and it is not clear that more experienced auditors will *cite* more violations even if they detect them. Scholarship on government regulatory agencies has suggested that new inspectors tend to exhibit "a more policing, nit-picking attitude" than more seasoned inspectors (Bardach and Kagan, 1982/2002: 129). Inexperienced inspectors "know too little about the industries and operations they are inspecting" and thus "lack the confidence to evaluate actual levels of risk" posed by particular violations, so they tend to go by the book and cite everything (Bardach and Kagan, 1982/2002: 129). Experienced inspectors, by contrast, may decline to cite violations lacking the requisite level of risk and culpability as they gain more confidence in their professional judgment (Bardach and Kagan,

1982/2002; Hawkins, 1984). We therefore expect that violation counts will initially rise with auditor tenure, as auditors gain the experience to detect violations, but that this effect will be tempered as the benefits of experience attenuate and as experienced auditors gain the confidence to exercise more discretion about which violations to cite.

Hypothesis 2 (H2): Audits conducted by more experienced auditor teams will yield more violations but at a decreasing rate.

Professionalization

Education and training are important sources of professional socialization that should impart to monitors both the skills to detect more violations and the sense of professional obligation to report violations to their principal (March and Olsen, 1998). Sociologists have long theorized that professionalization—specialized education and training in a field's skills and values—is a key constraint on individual discretion in both corporate and government bureaucracies (Abbott, 1988; Scott, 1966). Lipsky (1980/2010: 201), for instance, has argued that enhanced professionalism rationalizes the way front-line workers in government bureaucracies exercise discretion: "[S]treet-level bureaucrats should be professionals whose relatively altruistic behavior, high standards, and self-monitoring substitute for what the society cannot dictate. Who will watch the watchmen? The watchmen will watch themselves." Scholars have also suggested that professionalism can help internal corporate compliance monitors at for-profit firms resist the influence of economic pressures and perform their oversight functions more effectively (Parker, 1999). Research has demonstrated that professionalization can improve the efficacy of government labor inspectors (Piore, 2005; Schrank, 2009). We therefore expect that teams whose auditors are more professionalized will record more violations.

Hypothesis 3 (H3): Audits conducted by teams that include auditors who are more professionalized will yield more violations.

Gender

Research has suggested that, even when constrained by bureaucratic rules and roles, men and women

may perform their work “somewhat differently” (Eagly and Johannesen-Schmidt, 2001: 783). Several gender-based behavioral distinctions documented in the literature can influence whether social auditors discover—and also whether they cite—violations. Research has shown that women are more persistent at pursuing assigned tasks (Spence and Buckner, 2000; Stonewater, Eveslage, and Dingerson, 1990), potentially motivating them to search more diligently for violations. Research has also found that women have perceptual and integrative processing advantages that may enhance their ability to detect violations. For example, women have been found to be more skilled at interpreting the emotional content of others’ expressions (Killgore and Cupp, 2002; Thayer and Johnsen, 2000) and to be “more sensitive to subtle stimulus” (Darley and Smith, 1995: 43). Research has also found that women tend to use a more comprehensive information-processing style, whereby they “attempt to assimilate all available cues” (Darley and Smith, 1995: 43). According to Gold, Hunton, and Gomaa (2009: 3):

[W]omen tend to integrate more of the available evidential cues into their judgments, reflecting an intense level of cognitive processing. Men, on the other hand, tend to eliminate what they deem to be irrelevant cues and focus on a limited set of salient pieces of information that are relatively easy and quick to process.

Thus, women’s style of gathering and processing information may better equip them to perceive violations in a complex factory setting and to elicit information about violations from employees.

Moreover, research suggests that women are more likely to cite the violations they perceive. Women in bureaucratic organizations are more likely than men to be strict rule followers (Oberfield, 2010; Portillo, 2012; Portillo and DeHart-Davis, 2009). A long line of sociological scholarship has argued generally that “rules are a means of asserting power for the less powerful” (Portillo, 2012: 91) and that low-status members of organizations use rules as a source of authority to compensate for their lack of personal authority (Green and Melnick, 1950; Thompson, 1977). Although we know of no research on women’s status in supply chain auditing, research on financial auditors and audit

firms suggests that, even as many women have entered that profession, masculine organizational cultures still tend to devalue women’s contributions (Haynes, 2012; Jonnergård, Stafssudd, and Elg, 2010). Empirical studies of government workers find that women do indeed “go by the book” (Green and Melnick, 1950; Portillo, 2012; Portillo and DeHart-Davis, 2009) more strictly than their male colleagues do. This evidence suggests that supply chain auditors’ gender will influence whether they detect and cite violations.

Hypothesis 4 (H4): Audits conducted by all-female teams will yield more violations than those conducted by all-male teams.

Gender diversity

Supply chain auditing teams are not necessarily all male or all female. In the organizational literature on teams, there is significant debate about the effects of diversity, including gender diversity, on team performance (Joshi and Roh, 2009; Phillips *et al.*, 2012). We expect that mixed-gender audit teams will exhibit superior performance because they benefit from the complementarity of men’s and women’s different perceptual styles and from performance-enhancing interpersonal team dynamics.

First, women’s and men’s different perceptual styles may cause them to identify different types of violations, enabling mixed-gender teams to find more. This should be particularly valuable in eliciting information from a diverse set of employees and managers. Research has demonstrated that “diversity in groups increases the likelihood that there will be access to different information in a group” (Phillips *et al.*, 2012: 161). Our interviews with social auditors indicate that audited factories tend to have predominantly female workers and predominantly male managers and that the female workers are more likely to communicate openly with female auditors, while, as one interviewee put it, male supplier managers, “for cultural reasons, may find it difficult ... to open up to women.”¹

Second, research has shown how the interpersonal dynamics of gender diversity can improve team performance. For instance, studies find that people on socially diverse teams tend to prepare

¹ Personal interview with authors conducted September 2013.

more thoroughly and to think through a broader range of issues (Loyd *et al.*, 2013). Fenwick and Neal report the superior performance of gender-diverse teams in management-simulation exercises, crediting it to the “mix of male and female operating, decision-making and leadership styles” (Fenwick and Neal, 2001: 217). Furthermore, men on mixed teams may work harder if they sense they are being outperformed by women. Studies have shown that lower performing team members often compare themselves to better performers and that this motivates them to improve their performance to equal or exceed that of the stronger performers (Lount and Phillips, 2007; Weber, Wittchen, and Hertel, 2009). Weber *et al.* (2009) demonstrate that men are particularly prone to such competitive behavior. Male auditors may therefore feel compelled to match or beat their female teammates’ higher citation rates.

Although some evidence suggests that gender diversity can sometimes undermine team performance (Phillips *et al.*, 2012), a recent meta-study found that gender diversity is particularly likely to enhance performance in service industries, where team members interact directly with their clients and their clients’ employees (Joshi and Roh, 2009). Because supply chain auditing is a service industry and auditors interact extensively with the employees of the firms they audit, we expect gender diversity to improve team performance.

Hypothesis 5 (H5): Audits conducted by gender-diverse teams will yield more violations than those conducted by single-gender teams.

DATA AND MEASURES

Empirical context and sample

To test our hypotheses, we obtained data for thousands of code-of-conduct audits conducted between 2004 and 2009 by one of the world’s largest social auditing companies.² During that period, the company, which already had more than a decade’s experience, employed several hundred people in many countries; they spoke more than 30 languages.

The dataset contains audit results for and information about each audited supplier, including its

² The company required anonymity as a condition of sharing its data with us.

Table 1. Industry composition

Industry	Audits		Factories	
	Number	Percent	Number	Percent
Accessories	1,740	10	579	10
Building materials	260	2	84	1
Chemicals and plastics	97	1	42	1
Electronics	590	4	184	3
Food, agriculture, beverage	138	1	58	1
Footwear	356	2	122	2
Furniture	383	2	123	2
Garments	6,188	37	2,113	36
Metal products	156	1	51	1
Paper, printing, publishing	183	1	63	1
Services	50	0	19	0
Toys	463	3	150	3
Other/unknown	6,191	37	2,231	38
Total	16,795	100	5,819	100

country and a unique identifier; characteristics and unique identifiers for the auditors on each audit; and the country of the buyer on whose behalf each audit was conducted and a unique identifier for that firm. Our estimations are based on the 16,795 audits of 5,819 factories in 66 countries for which we had data on all the measures described below and which had been audited at least twice during the sample period (a technical requirement owing to our models being estimated with supplier-level fixed effects, described below). The industry composition of our sample is reported in Table 1; the most common industries are garments, accessories, electronics, and toys.³ In our dataset, the buyer firms (brands) nearly always determined which suppliers would be audited.⁴

Dependent variable

We measure the extent to which factories adhere to codes of conduct as the *number of violations* in each audit,⁵ obtained from the social auditing

³ The geographic distributions of audited establishments and audits are reported in Table B1 of Appendix S2.

⁴ Factories sometimes sought audits to become certified to a third-party standard such as SA8000. As described later, our results are robust to omitting the very small proportion of audits that used third-party protocols.

⁵ Studies of compliance with government health and safety regulations have long used violation counts recorded by inspectors as a

firm's database. We include only the types of violations that, according to the social auditing firm (hereafter referred to as "the auditing firm"), apply in all industries and are interpreted by auditors in the same way in all countries; namely, violations of rules for child labor, forced or compulsory labor, working hours, occupational health and safety, minimum wage, treatment of foreign workers and subcontractors, and disciplinary practices.⁶ During an audit, the auditors code a common set of dichotomous indicators (violation or no violation) in each category.⁷

Independent variables

To identify the potential for auditors' relationships with audited suppliers to influence the auditors' performance, we coded *previous auditor* as 1 when at least one member of the focal audit team had participated in one of the supplier's previous audits during the sample period and 0 otherwise.

We measure an auditor's experience as his or her years of service at the auditing firm based on data from the auditing firm's database. We calculated *maximum tenure* as the highest number of years that any member of the audit team had worked at the auditing firm.⁸

measure of compliance variation (Braithwaite and Makkai, 1991; Gray and Shadbegian, 2005) and more recent studies of supplier compliance with private labor standards have used violation data recorded by private auditors (Ang *et al.*, 2012; Oka, 2010).

⁶ We exclude other categories that, according to our auditor interviews, are applied only to certain factories or are interpreted differently in different countries: the right of association, the right to organize and bargain collectively, legal client regulation, dormitory conditions, and canteen violations.

⁷ The occupational health and safety category, for example, consists of seven indicators pertinent to emergency preparedness (blocked or locked aisles or exits, inadequate first-aid supplies, insufficient emergency exits, lack of emergency lighting, lack of employee emergency training, lack of an evacuation plan, and unmarked aisles), five indicators of fire safety, eight related to toilets, and eight related to the work floor.

⁸ Using average tenure rather than the maximum tenure yielded nearly identical results. Tenure is measured as work experience at our focal firm, where audit team tenure averages nearly five years, audit team age averages 30 years old, and nearly all auditors have at least a bachelor's degree. Tenure at the focal firm is thus a reasonable proxy for the entire auditing experience of many auditors in our sample. To assess whether the potential influence of unobserved auditing experience at prior employers might be driving our tenure results, we re-estimated our primary model on the subsample of audits for which the influence of prior auditing experience is least likely a concern: those conducted by relatively young auditors. Results estimated on the subset of audits conducted by teams whose maximum age was no more than 30 years old yielded coefficients on *maximum tenure* ($\beta = 0.06$,

We measure the professionalism of the audit team in two ways. Because one important source of professionalization is "standardized formal training in universities" (Lipsky, 1980/2010: 201), we code *graduate education* as 1 when at least one member of the audit team had a graduate degree and 0 otherwise. We focused on graduate education because nearly all auditors in our dataset had a bachelor's degree.⁹ We also created *auditing skills training* as the largest number of the auditing firm's training courses that any audit team member had completed. These courses teach skills such as how to interpret national labor laws and how to detect payroll manipulation that might indicate wage violations.¹⁰

We measure gender composition with three dummy variables—*all-female audit team*, *all-male audit team*, and *mixed-gender audit team*.¹¹

Control variables

Using the auditing firm's database, we calculated the proportion of each team that had undergone *certification training*—training on the standards and protocols of a particular certification regime, such as SA8000—because the firm indicated that such training influences the scope of the audit and the types of violation auditors look for. We also calculated the proportion of each team that had undergone *brand training*—training provided by the buyer on its corporate responsibility program and procedures—to account for possible variation in the stringency requested by different brands.

We created a proxy for each audit team's average age based on coarsened auditor age data provided by the auditing firm. To keep precise ages confidential,

$p = 0.01$) and *maximum tenure squared* ($\beta = -0.003$, $p = 0.04$) that are statistically significant and are of the same sign as those yielded by our primary model. This bolsters our confidence that tenure, despite being measured only at our focal firm, significantly influences audit results.

⁹ We coded graduate education as a dichotomous variable rather than a continuous measure to reflect better the near-binary distribution in our sample: 87 percent of the audit teams had no members with a master's degree, 7 percent had all members with a master's degree, and a mere 6 percent had an intermediate configuration.

¹⁰ Using the average rather than the maximum number of training courses yielded nearly identical results.

¹¹ We use these dummies rather than a continuous measure such as the proportion of the audit team that is female because the database indicated that 97 percent of the audit teams in our sample were all female, all male, or evenly divided. Thus, the three dummies represent the distribution of our data.

the firm provided five-year age-range categories (for example, 20–24 years old) for each auditor. We calculated the midpoint for each category and then created *average age* as the average of the oldest and youngest age-range categories on a team.¹²

We created a dummy variable to indicate whether an audit was conducted according to a *third-party protocol*—such as that of the Business Social Compliance Initiative (BSCI), the Initiative Clause Sociale (ICS), the Sedex Members Ethical Trade Audit (SMETA), the International Council of Toy Industries (ICTI), or Worldwide Responsible Accredited Production (WRAP).

We measure whether an audit is unannounced or pre-announced, using a dummy variable, *unannounced audit*, coded 1 for an unannounced audit and 0 for a pre-announced audit.

To indicate which entity paid for each audit,¹³ we created two dichotomous variables based on the auditing firm's database. *Audit paid for by supplier or agent* identifies audits with the potential for financial conflict of interest. It is coded 1 for audits paid for by the audited supplier or by agents, vendors, or licensees and coded 0 for audits paid for by the buyer.¹⁴ *Audit paid for by buyer* is coded in the opposite manner.

We include dummy variables to control for the *number of auditors* on each audit (2–5, with 1 as the omitted category).

Based on the auditor's database, we created a dummy variable to distinguish routine audits from *re-audits*, which tend to have a narrower focus on those domains in which violations were previously identified. We created dummies to

indicate a supplier's audit sequence—its *second audit*, *third audit*, and so on through *sixth-or-higher audit* (because only five percent of the audits in our sample were the seventh or higher), with a supplier's first audit as the omitted category.¹⁵

We measure a supplier country's average economic development in the year the audit was conducted as its annual *per-capita gross domestic product (GDP)* in 2005 dollars, calculated by the U.S. Department of Agriculture's Economic Research Service (obtained from <http://www.ers.usda.gov>). To reduce skew, we use the log. To measure the extent to which the government of the supplier's country fosters a regulatory environment promoting economic development, we use the annual *regulatory quality* metric corresponding to the year the audit was conducted, calculated by the World Bank's Worldwide Governance Indicators project (obtained from <http://data.worldbank.org/data-catalog/worldwide-governance-indicators>) to capture “perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development” (World Bank, 2013).¹⁶

We measure the extent of *press freedom* in the supplier's country the year the audit took place via the annual Press Freedom Index produced by Reporters without Borders (obtained from <http://en.rsf.org>). This index incorporates the extent to which journalists face direct and indirect threats—including imprisonment, physical attacks, censorship, and self-censorship—and the number of journalists detained, murdered, physically attacked, or threatened. We create annual *press freedom* by reverse-coding the Press Freedom Index, so that a higher score represents more press freedom, and then rescaling the result to range from 0 to 1.

Summary statistics are reported in Table 2.¹⁷

EMPIRICAL MODEL AND RESULTS

Our empirical model includes all independent and control variables described above and three sets of

¹² Using the oldest team member's age rather than the team's average age yielded nearly identical results.

¹³ In our dataset, buyers nearly always determined whether they or the supplier (or its agents) paid for an audit. Our interviews indicated that this decision was not driven by the supplier's managerial attitude, violation rate, or improvement rate. Factories sometimes sought and paid for audits when they sought to become certified to a third-party standard such as SA8000. As described later, our results are robust to omitting from the estimation sample the very small proportion of audits that used third-party protocols.

¹⁴ We combined these categories of payer because prior research and our auditor interviews suggest that, in our empirical context, the financial incentives of factories and these intermediaries are closely aligned. In developing economies, intermediaries' role is to promote exports by domestic manufacturers by identifying new markets for their goods and services (Ellis, 2011) and by reducing transaction cost barriers to export (Ahn, Khandelwal, and Wei, 2011). Our results are robust to an alternative specification in which we include two dummies that control separately for audits paid for by factories and audits paid for by agents, vendors, or licensees.

¹⁵ Using an *audit sequence* counter variable and its square rather than the dummies yielded nearly identical results.

¹⁶ Controlling instead for supplier countries' annual Corruption Perceptions Index scores from Transparency International, which are highly correlated with the World Bank's *regulatory quality* metric ($\rho = 0.96$), yields nearly identical results.

¹⁷ Correlations are reported in Table B2 of Appendix S2.

Table 2. Summary statistics

Variable	Mean	SD	Min	Max
Number of violations	6.49	5.61	0	75
Previous auditor	0.15	0.36	0	1
Maximum tenure	5.39	2.03	1	15
Average tenure	4.86	1.85	0.5	15
Graduate education	0.13	0.34	0	1
Auditing skills training	2.25	1.74	0	12
All-male audit team	0.33	0.47	0	1
All-female audit team	0.50	0.50	0	1
Mixed-gender audit team	0.17	0.37	0	1
Certification training	0.50	0.42	0	1
Brand training	0.59	0.43	0	1
Average age	30.12	4.47	22.5	59
Maximum age	30.62	4.66	25	59
Third-party protocol	0.04	0.19	0	1
Unannounced audit	0.22	0.41	0	1
Audit paid for by supplier or agent	0.56	0.50	0	1
Audit paid for by buyer	0.44	0.50	0	1
Re-audit	0.36	0.48	0	1
Number of auditors	1.79	0.58	1	5
Audit sequence	2.96	2.25	1	21
Per-capita GDP (log)	7.77	0.98	5.61	10.68
Regulatory quality	-0.04	0.54	-1.64	1.99
Press freedom	0.33	0.27	0.12	1.00

Note: N = 16,795 audits except N = 15,812 for *audit paid for by supplier or agent* and *audit paid for by buyer*, N = 11,337 for *average age* and *maximum age*, and N = 16,676 for *press freedom*.

fixed effects. Specifically, we estimate the following model:

$$Y_{icdj} = F(\beta_1 X_{id} + \beta_2 \phi_{id} + \beta_3 \lambda_{cd} + \beta_4 \alpha_i + \beta_5 \delta_i + \beta_6 \gamma_j + \varepsilon_{icdj}),$$

where Y_{icdj} refers to the *number of violations* recorded in the audit of supplier i in country c that was conducted on date d on behalf of a buyer in country j . $F(\cdot)$ refers to the Poisson function. X_{id} refers to our hypothesized variables (*previous auditor*, *maximum tenure*, *average tenure*, *graduate education*, *auditing skills training*, *all-male audit team*, *all-female audit team*, and *mixed-gender audit team*).

ϕ_{id} refers to the audit-level control variables described above. We control for *certification training* and *brand training* because these types of training might influence an audit team's ability to detect and report violations or the nature of the violations it detects and reports and because prior

research has indicated that training can influence the stringency of government monitors (Macher *et al.*, 2011). We control for audit teams' *average age* and its square to ensure that the effects of auditor tenure can be attributed to job experience rather than to the life-cycle effects posited by human capital theory (Diamond, 1984), which predicts "an inverse U-shaped relationship between productivity and age" (Teitelbaum, 2006: 166). We control for whether an audit was conducted according to a *third-party protocol* because such protocols might limit an auditor's discretion. We control for whether an audit was an *unannounced audit* or an *announced audit* because the latter provides several weeks of notice that might enable the supplier to remedy violations before the audit. We include controls for which entity paid for the audit (*audit paid for by supplier or agent* and *audit paid for by buyer*) because research has indicated that financial conflicts of interest created by audit fees undermine auditors' and inspectors' stringency (Duflo *et al.*, 2013; Moore *et al.*, 2006; Partnoy, 2006). We also control for whether an audit is a *re-audit* because those tend to focus on the domains in which violations were previously identified and therefore can yield fewer violations than routine audits. We include dummies to control for the *number of auditors* because larger audit teams are assigned to larger and more complex establishments and because prior research has shown that larger teams of government inspectors can lead to more stringent monitoring (Muehlenbachs *et al.*, 2013). We include dummies indicating the supplier's *audit sequence* to control for the possibility that successive audits yield fewer violations as factories address the issues exposed.

λ_{cd} refers to the annual supplier-country control variables described above: *per-capita GDP (log)*, *regulatory quality*, and *press freedom*. These country-level governmental, economic, and civil-society attributes control for institutional factors that can influence a supplier's compliance with codes of conduct (Toffel, Short, and Ouellet, 2015). γ_j refers to fixed effects for the headquarters country of the buyer firm (brand) on whose behalf each audit was conducted. This controls for the possibility that consumers and activist groups in different countries vary in their concern for and attentiveness to supply chain conditions, which might in turn affect how much pressure firms headquartered in those countries exert on their

supply chain auditors to audit stringently (Toffel *et al.*, 2015). These fixed effects also control for all other time-invariant differences between the headquarters countries' institutional contexts.

We include fixed effects for each supplier (α_i) to control for time-invariant characteristics that might affect its violation rate, such as size, age, industry, and national institutional context.¹⁸ Dummies for the audit year (δ_t) control for overall temporal trends.

Our identification strategy is based on the fact that the process of assigning auditors to audit teams is unrelated to our independent variables and thus is not a source of endogeneity that should bias their coefficients. Specifically, our interviews with the auditing firm indicated that assignments were based on (1) language skills to communicate with management and workers, (2) availability, and (3) the need for at least one team member to qualify as a lead auditor.¹⁹

Results

We estimate the model using Poisson regression with robust standard errors and report our results in Column 1 of Table 3. Negative binomial regression with conditional fixed effects yields nearly identical results, indicating that our results are not sensitive to estimation technique. Variance inflation factors (VIF) were below 2 for all hypothesized variables and below 5 for all variables except a few buyer-country dummies, which yields no evidence that multicollinearity is a serious concern. The explanatory power of the model is indicated by a McFadden's R-squared value of 0.39 and a McFadden's adjusted R-squared value of 0.30.

The significant negative coefficient on *previous auditor* ($\beta = -0.04$; $p = 0.03$; IRR = 0.96) indicates that audits yield four percent fewer violations when a team member had participated in a prior audit of the same supplier, which supports Hypothesis 1. The average marginal effect (AME) of -0.3 indicates that, compared to the sample average of

6.5 violations, an audit by a team with a previous auditor would yield 6.2 violations.

The audit team's maximum tenure has a significant positive coefficient ($\beta = 0.07$; $p < 0.01$) and its square term has a significant negative coefficient ($\beta = -0.004$; $p < 0.01$), implying that the number of violations cited increases as tenure increases but at a diminishing rate, which supports Hypothesis 2.²⁰

Our results are mixed with respect to professionalization. The coefficient on *graduate education* is positive as predicted but not significant, yielding no evidence that audits conducted by teams with more formal education yielded significantly more violations. Audits did yield significantly more violations when conducted by more professionalized auditors as measured by *auditor training* ($\beta = 0.02$; $p < 0.01$; IRR = 1.02). This result is not driven by age or tenure, for which we control. The AME indicates that each additional training course (beyond that possessed by the team's most highly trained member) is associated with an additional 0.14 violations. In other words, an audit team whose most highly trained member had taken nine training courses would, on average, cite one more violation than a team whose most highly trained member had taken two training courses. Jointly, these results yield some support for Hypothesis 3, but only when professionalization is measured by specific training rather than by broader education.

Team gender composition is also significantly associated with the number of violations reported. Audits by all-female teams yield six percent more violations than those by all-male teams (the baseline) ($\beta = 0.05$; $p < 0.01$; IRR = 1.05), which supports Hypothesis 4. The average marginal effect indicates that audits by all-female teams yield 0.35 more violations than those by all-male teams (the baseline category).

Mixed-gender teams yield on average seven percent more violations—or nearly half a violation more—than all-male teams (the baseline) ($\beta = 0.07$; $p < 0.01$; IRR = 1.07) and slightly more violations than all-female teams ($\Delta\text{AME} = 0.1$), but the latter difference is not statistically distinguishable ($\chi^2 = 0.55$; $p = 0.46$). These results partially support Hypothesis 5.

¹⁸ Because supplier-level fixed effects in our model absorb the time-invariant portion of supplier country-level variables, *per-capita GDP*, *regulatory quality*, and *press freedom* effectively control for within-country temporal variation in their effect on supplier violation rates.

¹⁹ Potential concerns that endogenous audit assignment might bias results led us to conduct several supplemental analyses described below and in Appendix S1.

²⁰ This relationship is illustrated in Figure C1 of Appendix S3, which graphs average predicted violations at varying levels of the audit team's maximum experience.

Table 3. Regression results

Dependent variable: number of violations	Coef.	(1)	(2)	(3)	(4)	(5)
		Average marginal effects	Coef.	Coef.	Coef.	Coef.
H1 Previous auditor	−0.043* (0.020)	−0.28	−0.039+ (0.020)	−0.028 (0.026)	−0.044* (0.021)	−0.027 (0.025)
H2 Maximum tenure	0.065** (0.014)	0.12	0.068** (0.014)	0.078** (0.016)	0.069** (0.014)	0.084** (0.017)
H2 Maximum tenure squared	−0.004** (0.001)		−0.004** (0.001)	−0.004** (0.001)	−0.005** (0.001)	−0.005** (0.001)
H3 Graduate education	0.027 (0.024)	0.18	0.030 (0.024)	−0.004 (0.029)	0.021 (0.026)	0.045 (0.039)
H3 Auditing skills training	0.021** (0.007)	0.14	0.022** (0.007)	0.013 (0.009)	0.022** (0.007)	0.012 (0.009)
H4 All-female audit team	0.054** (0.015)	0.35	0.055** (0.015)	0.048* (0.019)	0.053** (0.016)	0.052* (0.021)
H5 Mixed-gender audit team	0.067** (0.021)	0.43	0.068** (0.021)	0.049* (0.024)	0.069** (0.021)	0.067* (0.028)
Certification training	−0.021 (0.021)	−0.14	−0.024 (0.021)	−0.027 (0.027)	−0.031 (0.021)	−0.010 (0.029)
Brand training	−0.014 (0.021)	−0.09	−0.012 (0.022)	0.008 (0.026)	−0.007 (0.022)	0.001 (0.030)
Average age	−0.025 (0.019)	−0.04	−0.026 (0.020)	−0.015 (0.028)	−0.023 (0.019)	−0.041 (0.027)
Average age squared	0.000 (0.000)		0.000 (0.000)	0.000 (0.000)	0.000 (0.000)	0.001 (0.000)
Third-party protocol	−0.080 (0.058)	−0.52	−0.088 (0.062)	−0.148* (0.070)		−0.210* (0.101)
Unannounced audit	0.029 (0.020)	0.19	0.029 (0.020)	0.030 (0.025)	0.031 (0.020)	0.075** (0.027)
Audit paid for by supplier or agent	−0.084** (0.026)	−0.55	−0.083** (0.027)	−0.068* (0.032)	−0.064* (0.028)	−0.099** (0.034)
Re-audit	−0.348** (0.016)	−2.26	−0.351** (0.016)	−0.353** (0.019)	−0.358** (0.017)	−0.345** (0.020)
Per-capita GDP (log)	−0.623* (0.262)	−4.04	−0.551* (0.264)	−0.749 (0.473)	−0.714** (0.267)	−0.210 (0.389)
Regulatory quality	−0.180 (0.150)	−1.17	−0.169 (0.150)	−0.385 (0.298)	−0.158 (0.153)	−0.621** (0.231)
Press freedom	−0.510* (0.224)	−3.31	−0.531* (0.224)	−1.059* (0.476)	−0.402+ (0.239)	−0.879** (0.339)
Observations (audits)	16,795		16,585	10,648	16,044	9,266
Factories	5,819		5,748	3,810	5,523	3,082

**p < 0.01; *p < 0.05; +p < 0.10

Standard errors clustered by supplier (factory). All models also include fixed effects for the audited establishment, audit year, buyer country, number of auditors (two through five or more), and the supplier's audit sequence (second through sixth or more). All models include three dummy variables to indicate instances in which the following variables were missing data and thus recoded to 0: *average age* and *maximum age* (5,458 audits), *audit paid for by supplier or agent* and *audit paid for by buyer* (983 audits), and *press freedom* (119 audits). Model 1 is the primary model estimated on the entire sample. Model 2 excludes audits conducted for buyers whose audit teams were always all female. Model 3 includes only audits conducted by at least two auditors. Model 4 excludes audits conducted according to a third-party protocol. Model 5 excludes factories' first audit during the sample period.

The coefficients on *second inspection* through *sixth or more inspection* are negative and significant. Wald tests comparing these coefficients indicate that, on average, each successive audit yields significantly fewer violations. AMEs indicate that, on average, a supplier's second audit yields nearly

one fewer violation than its initial audit during our sample period ($\beta = -0.15$; $p < 0.01$; $AME = -0.9$), its third audit yields nearly 1.3 fewer than its second audit ($AME = -2.2$, a statistically significant decline: Wald $\chi^2 = 114$; $p < 0.01$), and its fourth audit yields 0.6 fewer than its third audit

(AME = -2.8, a statistically significant decline: Wald $\chi^2 = 20$; $p < 0.01$).²¹

Consistent with assigning more auditors to larger factories, which are likely to generate more violations, we find that audits with more auditors yield significantly more violations. We find no evidence that the number of violations varied with the team's certification training, brand training, or average age or with a third-party protocol. Our point estimate indicates that unannounced audits yielded slightly more violations than announced audits at a given supplier (AME = 0.2), but the difference was beyond conventional significance levels ($p = 0.15$).

Audits paid for by factories or agents yielded eight percent fewer violations than audits paid for by the buyer, the baseline category ($\beta = -0.08$; $p < 0.01$; IRR = -0.92). The average marginal effect indicates that, on average, audits yield 0.6 fewer violations when the supplier or agent pays than when the buyer pays, a drop from 6.5 to 5.9.

Audits yielded fewer violations in countries with greater per-capita GDP ($\beta = -0.62$; $p = 0.02$; AME = -4.0) and in those with greater *press freedom* ($\beta = -0.51$; $p = 0.02$; AME = 3.3). Our point estimate indicates fewer violations at factories in countries with higher *regulatory quality*, but the relationship was not statistically significant ($\beta = -0.18$; $p = 0.22$).

Robustness tests

Potential concerns that endogenous audit assignment—and, in particular, differences between lead auditors and other auditors—might bias our results led us to conduct several supplemental analyses. As described in Appendix S1, instrumenting for the audit team's maximum *auditing skills training* and *maximum tenure*—using average values of these characteristics among all auditors based in the auditing firm's field office that staffed each establishment's audits, an approach based on Card (1995) and Forman, Goldfarb, and Greenstein (2012)—yielded results statistically indistinguishable from our primary results (Hausman test $\chi^2 = 52.09$; $p = 0.16$), thus offering no evidence of endogeneity bias.

Estimating our primary model using negative binomial regression yielded results nearly identical

to those of our primary approach, which used Poisson regression. We also estimated our primary model on various subsamples to assess the extent to which our results were driven by certain types of audits. Column 2 of Table 3 reports estimates after excluding the 210 audits performed for buyers whose audit teams were always all female, in case that pattern reflected a buyer-firm policy that might bias our results. Column 3 reports estimates based on the 10,648 audits conducted by teams of at least two; this is to ensure that our results were not driven by single-auditor audits. Column 4 reports estimates after excluding the 751 audits conducted according to third-party protocols, in case the influence of such protocols on the discovery or reporting of violations is not adequately controlled for with the dummy variable used in our main specification and also because, in these cases, the factories themselves might have chosen the protocol and auditor. Column 5 reports results for the subsample of 9,266 audits that excludes each supplier's first audit in our sample; some of those might have been pre-assessments of factories that buyers had not yet engaged and our hypothesized relationships might operate differently in such cases. Our results are quite robust across these subsamples. The signs and magnitudes of all hypothesized variable coefficients are very similar to those in our main results.

DISCUSSION

Our research indicates that supply chain auditors' identification and reporting of violations of supplier codes of conduct are shaped not only by the financial conflicts of interest that have been the focus of research to date, but also by social factors that include the auditors' experience, professional training, and gender; the gender diversity of their teams; and their repeated interactions with those whom they audit. These findings contribute to the TCE stream within the strategic management literature and to the transnational business regulation literature. Our results also suggest strategies for designing private monitoring regimes to provide companies with more reliable strategic information about their supply chain partners.

Contributions to the strategic management literature

While the TCE literature highlights the important governance function of monitoring, it contains

²¹ This relationship is also apparent in the summary statistics depicted in Figure C2 of Appendix S3.

little empirical research on monitoring and has not addressed monitoring's distinct role in managing reputational risk in global supply chains. Our study significantly extends the TCE literature on monitoring to address this key strategic concern. First, we highlight the particular importance of supply chain monitoring in mitigating the risk of reputational spillover. The TCE literature on global outsourcing has largely assumed that the transaction costs of outsourced production are dwarfed by its production economies and, moreover, that these costs are becoming vanishingly small as advances in digital communication radically reduce information, bargaining, and monitoring costs (e.g., Levy, 2008). We argue that this perspective obscures the potentially large reputational spillover costs of outsourcing to suppliers with poor social or environmental practices. Our findings suggest that outsourcing firms must carefully consider whether their monitoring arrangements are well designed to manage these costs effectively and at what point the costs of effective monitoring become sufficiently large to undercut the economic gains of outsourcing production. These insights bridge the TCE literature with strategic management perspectives on reputation (Roberts and Dowling, 2002).

Second, we extend the existing literature's focus on the *ex ante* design of monitoring structures to highlight the need for effective ongoing *ex post* monitoring to safeguard against opportunism in outsourcing relationships. TCE studies of monitoring have tended to focus on "ex ante safeguards to deter ex post opportunism" (Williamson, 2008: 6), such as the appropriate design of contractual provisions (Argyres *et al.*, 2007; Barthélemy and Quélin, 2006; Gereffi *et al.*, 2005). Our empirical documentation of heterogeneity in the reliability of information generated by monitors makes it clear that for monitoring to mitigate the costs of reputational spillovers, it must be not only properly designed but also effectively implemented.

Third, we extend TCE's foundational concern with the bounded rationality of contracting parties (Williamson, 1979) to third parties—those who support outsourced transactions—by demonstrating the ways in which these actors are likewise constrained by social, cognitive, and relational factors. Research addressing the limitations of monitors has, to date, focused on their opportunistic behavior (Khalil and Lawarrée, 2006) rather than on more generic constraints on their rationality. More generally, the literature tends to

assume that monitoring is becoming increasingly effective because of "[advances in] technology, standardization of business processes, and plunging communication costs" (Geis, 2007: 998), but this perspective fails to acknowledge that individuals engaged in monitoring activities remain subject to the limits of bounded rationality. Our research identifies this important oversight and suggests ways that managers can economize on not only their own bounded rationality, but also that of their monitors.

Finally, we identify important second-order monitoring problems that arise when firms outsource monitoring functions to third parties. Existing TCE accounts tend to assume that monitoring is carried out by the transacting parties themselves. Increasingly, however, these functions are performed by private, third-party firms such as social auditors, certification organizations, assurance services, and consultants. This introduces potential agency problems, because third-party monitors often have different incentive structures from the principals that hire them (Khalil and Lawarrée, 2006; Pierce and Toffel, 2013). Our study highlights the need for greater attention to these complex governance structures and our findings offer strategies that firms can use to monitor their monitors and increase the reliability of the strategic information those monitors supply. These strategies, discussed below, are relatively cost-effective ways to economize on monitors' bounded rationality.

Contributions to the transnational business regulation literature

Supply chain auditing has become an important component of transnational business regulatory schemes that seek to address the social and environmental risks of global business activities (Braithwaite and Drahos, 2000; Toffel *et al.*, 2015). Private labeling regimes such as the Forest Stewardship Council, the Marine Stewardship Council, and Fair Trade rely on private third-party auditors. International intergovernmental institutions such as the United Nations have encouraged supply chain auditing by requesting that MNCs conduct "due diligence" to ensure their suppliers' compliance with international human rights norms (Ruggie, 2008). Many national regulators have followed suit, requiring MNCs to conduct due diligence and disclose supply chain practices (Zandvliet, 2011). The efficacy and legitimacy of transnational business regulation depends largely on the credibility of

private monitoring; our study responds to calls for more empirical research on the key actors (Büthe, 2010). While our findings of auditor heterogeneity support those who question the independence and objectivity of private monitors (Boiral and Gendron, 2011; Power, 1997), our identification of several systematic determinants of that heterogeneity suggests how companies and policymakers can improve audit validity. In addition, as governments begin to mandate certain environmental and social standards and sustainability disclosures that were once voluntary, our findings can help firms develop compliance strategies to mitigate emerging legal risks associated with supply chain monitoring.

Implications for managers

Our study reveals some key characteristics of audit teams that can enhance audit quality, providing valuable guidance for companies that hire auditors to monitor their suppliers as well as for the auditing firms that do the monitoring. More broadly, our findings can inform those who hire or manage other private gatekeepers, such as accounting firms and credit rating agencies—subjects of much interest since their failures to detect and reveal corporate wrongdoing led to corporate scandals and financial meltdowns in the early 21st century (Partnoy, 2006).²² Our work should also spur companies employing internal auditors to monitor their suppliers to consider whether the mechanisms revealed in this study are at play.

Research suggests that managers tend to assume the professional independence and objectivity of their supply chain auditors (Dogui, Boiral, and Gendron, 2013). Our interviews with managers of companies that hire supply chain auditors indicate that these managers pay a great deal of attention when selecting audit firms, but then mainly leave it to the auditing firms to select the individual auditors who assess their suppliers. It may seem logical to “leave it to the experts,” but our results show that audit report quality suffers when the corporate client overlooks the auditor assignment process. In particular, managers of companies that hire supply chain auditors should pay closer attention to auditor training and experience, the gender composition of

teams, and auditor rotation. Our work also confirms prior research that questions the quality of audits paid for by the audited factory.

Moreover, our interviews with managers of several supply chain auditing firms indicate that, when composing audit teams, they do not consider the key characteristics we identified. Auditor assignments are based largely on logistical considerations like availability, language skills, minimum required training, and (in some cases) industry-specific experience. None of the managers we interviewed indicated that they considered gender. Few expressed concerns about re-assigning auditors to a supplier, though several remarked that doing so could expedite the audit (thereby reducing its cost) by leveraging the auditors’ familiarity with the facility and staff.

Considering these prevailing practices, our results equip both the managers of firms that hire supply chain auditors and the auditing firms themselves to understand better how team characteristics can influence audit quality. Our interviews with several auditing firms indicate that clients have the ability to influence audit team composition, but very few clients actually seek to do so. Greater consideration by clients to their auditing firms’ team composition can increase those firms’ attention to assessing and improving audit quality.

Because we find that auditors tend to cite fewer violations at factories where they have ongoing relationships, client firms should consider requiring that their auditing firms regularly rotate the auditing staff.²³ There are also clear managerial implications from our finding that audit teams whose members had more training documented significantly more violations than less well-trained teams did. Clients should insist that highly trained auditors be assigned to their suppliers, while auditing firms truly dedicated to providing reliable audits—observable when different audit teams yield indistinguishable audit reports—should reassess their minimum training requirements.

Auditing firms and their clients should also mind the gender composition of audit teams. Our findings

²² The gatekeeper literature, like the auditing literature, has focused almost exclusively on the influence of economic conflicts of interest (Bazerman *et al.*, 1997; Moore *et al.*, 2006; Partnoy, 2006).

²³ Others have advocated rotation of auditors (e.g., Moore *et al.*, 2006; U.S. Public Company Accounting Oversight Board, 2011), although such calls have focused on financial auditors and on rotation of audit *firms* rather than of individual auditors. A few schemes have explicitly stipulated term limits for auditing companies; for example, California’s greenhouse gas regulation requires regulated entities to change verification companies every six years.

reveal that all-male teams yielded significantly fewer violations. Audit firms should examine how gender composition leads to such disparities so that they can enhance their training to achieve better the goal of audit teams yielding comprehensive results irrespective of gender composition. In the meantime, companies hiring supplier auditors should examine whether their audit results correlate with the gender composition of their audit teams and, if so, press those firms to understand why. This might lead clients to develop evidence-based policies for their third-party auditors to follow when assembling audit teams. If more clients seek to influence audit team composition in order to increase audit quality, auditing firms may begin to compete on their attention to—and ongoing assessment of—audit quality. Should such client demands face insurmountable resistance from auditing firms in some markets, clients should consider relying on their own employees to monitor their suppliers in those markets.

Limitations and future research

Given the nature of our large quantitative study, we are unable to pinpoint the precise mechanisms by which the factors we identify influence individual auditor decisions. We encourage future research to investigate the social processes underlying these outcomes.

Discussions with social auditors at the firm that provided our data and at competing firms provoked no suspicion that endogeneity drives our results. Its team assignment process (described earlier) yields no endogeneity concerns that would drive our hypothesized results. Our discussions also indicated that MNCs determine which factories are audited, obviating the risk of a selection effect whereby better-than-average or worse-than-average factories choose to be audited or to pay for their own audits, as happens in some voluntary environmental programs (King and Toffel, 2009). Even so, we cannot rule out the possibility that omitted variables are correlated with our independent variables and violation rates; we therefore encourage future randomized field experiments (e.g., Hainmueller, Hiscox, and Sequeira, 2015).

Our findings relating to gender and gender diversity may be influenced by the gender composition of the supplier's workforce. Although we do not have such demographic data, available meta-data and our own interviews with social

auditors suggest that women dominate the workforce in the export-intensive industries—such as garments, textiles, and electronics—that account for most of our sample (Dejardin and Owens, 2009). Future research could explore how auditors' decisions are influenced by the interaction of the gender composition of the audit team and that of the audited organization. Similarly, future research could explore the influence of auditors' cultural backgrounds and, especially, how that might influence their interactions with the supplier's management and workforce.

Future research can also explore how auditors' decisions are influenced by various short- and long-term organizational structures and incentives. For instance, differing compensation systems may influence the extent to which supply chain auditors' decisions are shaped by economic incentives and other factors. Field experiments might show which technical and managerial training most improves auditors' objectivity. More broadly, it is important to investigate whether our findings are generalizable to other types of private gatekeepers, such as financial auditors, credit rating agencies, and attorneys. Do they respond similarly to economic incentives, professional obligations, and social pressures? Direct comparison of the practices of private-sector monitors such as social auditors and public-sector monitors such as government inspectors could reveal opportunities to enhance the efficiency and effectiveness of both. For example, whereas less stringency has been observed among more experienced government inspectors (Lemley and Sampat, 2012; Macher *et al.*, 2011), we observe greater stringency (albeit at a decreasing rate) among more experienced private monitors. Finally, from the TCE perspective, it is important to investigate whether social monitoring actually does mitigate reputational transaction costs for outsourcing firms, either by improving the supplier's social practices or by providing firms with timely actionable information.

CONCLUSION

Although private supply chain auditors are increasingly important to strategic corporate outsourcing decisions and to public and private transnational business regulation, they have seldom attracted academic attention. Our investigation of supply chain auditing practices at thousands of factories

around the world reveals several social factors that influence auditors' decisions. More broadly, our work contributes to the literatures on strategic management, private supply chain monitoring, and regulatory compliance mechanisms and highlights opportunities to improve the design and implementation of governance regimes monitoring outsourced production.

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SUPPORTING INFORMATION

Additional supporting information may be found in the online version of this article:

Appendix S1. Endogeneity assessment.

Appendix S2. Sample description.

Appendix S3. Figures depicting results of empirical analysis.