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Minimizing Perverse Incentives in Quality Assurance

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With the growth of unaccredited educational providers, students are facing a barrage of unsubstantiated claims around the outcomes these different providers produce. Knowing where to invest their time and money in learning is becoming more and more difficult. Similarly, employers and state governments face challenges in knowing from where to hire and which providers to allow to operate, respectively.

The Department of Education's launch of the Educational Quality through Innovative Partnerships (EQUIP) program has also brought the federal government into the fray, as EQUIP allows non-traditional providers of education to partner with accredited colleges and universities to have access to federal aid for students.

These developments necessitate the emergence of a third-party quality assurance system for the health of the industry and its student, employer, and government stakeholders. The EQUIP program has jump-started the creation of such a system through a set of Quality Assurance Entities (QAEs), which would monitor student outcomes at experimental sites to determine eligibility for federal loans and grants.

The establishment of an auditing framework that examines outcomes is exciting, as it begins to transform the evaluation of "quality" in higher education away from inputs and towards outcomes. This is important because focusing on inputs locks institutions into a fixed way of doing things and inhibits the ability to innovate. Focusing on outcomes, however, encourages continuous improvement toward an overall set of goals—in this case, goals around student success.

Auditing outcomes, however, is fraught with potential conflicts of interest, as the most likely financial models for a third-party quality assurance system involve educational programs themselves paying the QAE for its services.

Because the third-party role is new, little thought has been given to how to mitigate these conflicts of interest. We believe it is imperative to create guidelines for how QAEs function and what entities may serve as a QAE.

What We Believe

1. Quality assurance should focus on outcomes, not inputs.
2. Standards should be open, and findings should be transparent.
3. No organization should own a monopoly on quality assurance.
4. Metrics used should encourage institutions to innovate to better serve students.
5. With students' futures hanging in the balance, quality assurance should operate according to the highest standards governing auditing and thus should mirror provisions in Sarbanes-Oxley.
6. Programs should be free to work with at least two entities around the representation of its outcomes--a primary QAE that audits an educational program's claims and controls and a secondary set of entities--quality assurance consultant--that help the program develop its internal processes and controls for making those claims. For the purposes of creating rules to mitigate potential conflicts of interest, the focus should be on the primary QAE that evaluates a program's claims.

Conflicts Of Interest

A conflict of interest arises when an existing situation creates the risk whereby professional judgment regarding a primary interest may be unduly impacted by a secondary interest.

There is an inherent conflict in any system requiring an organization to pay an entity to perform an audit or rating function. As such, the primary QAE role, as defined within EQUIP, is susceptible to justifiable concerns. The answer, however, is not to shutter the endeavor altogether--particularly given that the existing system of accreditation that controls access to Title IV dollars suffers from the same structural issue. Instead, it is critical to establish controls that 1) encourage auditors to perform thorough and exhaustive audits in spite of this conflict and 2) mitigate further development of conflicts of interest.

Other domains, from publicly traded companies working with auditors to certification organizations that give public seals of approval and ratings, have grappled with similar challenges under equally important circumstances. They have created solutions that allow entities to monitor an organization's performance claims and provide better transparency than would have otherwise existed for consumers.

The rules governing the financial auditing of publicly traded companies are among the most stress tested of such solutions. Specifically, Sarbanes-Oxley has set the gold standard for auditing claims of performance. Although there is evidence to suggest that the Sarbanes-Oxley regulatory regime has stifled small businesses and innovation because of its reporting requirements, the reasons for the protections it has established are, in certain key respects, similar to the reasons for protections around auditing educational institutions' performance claims. As such, its rigorous set of standards for monitoring and reporting on an entity's claims around outcomes seems appropriate for the higher education sector.

As the "Final Rule: Revision of the Commission's Auditor Independence Requirements" states, "Independent auditors have an important public trust. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional, and that investors, therefore, can rely on them. If investors do not believe that an auditor is independent of a company, they will derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities."[1] In other words, according to these regulations, the ultimate master of the auditor is the investing public.

The basis of our framework for quality assurance is modeled on that used within financial accounting in general and Sarbanes-Oxley in particular for a similar reason. Students invest their time, money, and passions with higher education providers. They should have confidence that they can rely on providers' reported outcomes. QAEs should provide students and families with critical assurance that the public statements of performance have been subjected to a rigorous examination by an objective, impartial, and skilled professional on which they can rely. This means that policy should promote both QAE objectivity in an absolute sense and, equally, institute measures so that the public believes that the QAEs are unbiased.

Three key principles emerge from that framework for the purposes of establishing a robust quality assurance framework when higher education focuses on outcomes.

Key Principle 1: The entity that evaluates an educational program's claims around outcomes must be independent of the program, which means that the entities must not have a deeper economic affiliation.

The principle ensures that the QAE is independent of the educational program both in fact and appearance. The purpose of the principle is to allow a QAE to make an honest assessment of the educational program's claims around outcomes without facing undue pressure from management to shape its recommendations in light of its other interests. A QAE should be able to provide a negative audit finding without risking significant economic harm at the hands of the program it is reviewing.

Some common connections that the entity and the evaluated program must avoid include:

Vendor or Consulting Relationship that Provides Non-Audit Services

Neither the entity nor the members (including immediate family members) undertaking the quality assurance evaluation for the entity should engage in other non-audit business (e.g., as a vendor or consultant) with the target program. The existence of such a relationship creates an opportunity whereby the potential for economic loss could interfere with a QAE's thorough and objective review. In addition, because the role of a QAE is to establish programmatic quality, and it is often in the interest of a consultant that the clients with whom they work are perceived as "high quality," the possibility of reputational risk for the consultant presents an additional opportunity for conflict.

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[1] See "Final Rule: Revision of the Commissioner's Auditor Independence Requirements," Securities and Exchange Commission, Effective Date: February 5, 2001, https://www.sec.gov/rules/final/33-7919.htm. This document makes clear that there are many disagreements among both academics and practitioners about what policies lead to auditing objectivity, but, by and large, we think the effort to strike a balance between creating true independence for the auditors from the firms they were auditing and a reasonable standard that was not so onerous as to be unreasonable and absurd has held up well over the last 15 years and thus provides a good model for higher education. The most updated regulations based on Sarbanes-Oxley are in this document: Strengthening the Commission's Requirements Regarding Auditor Independence, Securities and Exchange Commission, Effective Date: May 6, 2003. http://www.sec.gov/rules/final/33-8183.htm.

There are three principles of independence at stake here.[2] First, an auditor cannot function in a management role. Second, an auditor cannot audit its own work. And third, an auditor cannot serve in an advocacy role for its client.

Accordingly, given that a QAE will monitor a program's controls, it is likely that programs will solicit external advice on their internal operations. Similarly, Section 404 of Sarbanes-Oxley requires auditors to report on the scope and adequacy of a company's internal controls and their effectiveness. For the most part, this requires a company to hire two separate auditors—one to consult on the development of the internal controls and another to evaluate those controls.

Although this is an unpopular provision because of the burden and expense foisted upon smaller companies in particular, we believe that, given the impact on students' futures, the most rigorous standards should be applied to quality assurance in higher education.

It follows that the secondary entity (or entities)--the quality assurance consultant--that consults on the development of the internal controls may have other relationships with the program being evaluated—including consulting and financial ties—but the QAE that evaluates the effectiveness of the controls should have no other ties to the party or parties delivering the educational program.

Direct Investment
Neither the entity nor the members (including immediate family members) undertaking the quality assurance evaluation for the entity should have a direct investment in the program it is evaluating or else it might have an incentive to overlook deficiencies in the program so as to gain financially.

Lending Interest
The entity must not operate as a lender to students that attend the program. Although on the surface it might seem that an entity that lends to students would have its incentives aligned perfectly with the objective of evaluating a program's outcomes fairly and transparently—as it is in its interests that students attend programs where they can be successful and repay their loans—the reality is more complicated.

Lenders make money based on their loans being repaid. This requires that graduates get and keep jobs so they can repay loans. Graduates are able to get jobs based, in part, on the perception of the quality of their school. Employers are more likely to recruit and hire from schools with good reputations. If a QAE gives a school a negative audit, its graduates will be less likely to get jobs, which means lenders are less likely to be repaid. As a result, although a lender does have an incentive to work with quality programs at the outset, they have a disincentive to report objectively on program quality if and when elements of a program's quality adversely change over time. As with an entity that provides other non-audit services to

[2] These are the same principles outlined in "Strengthening the Commission's Requirements Regarding Auditor Independence, Securities and Exchange Commission, Effective Date: May 6, 2003. http://www.sec.gov/rules/final/33-8183.htm.

an institution, a lender can certainly support a program in developing its internal controls and developing its data sources as an quality assurance consultant.

Membership Groups/Trade Associations

The entity that audits a program must not be a membership group that receives fees from its members and subsequently self-regulates its member's programs. The reason is that the entity may have an interest in overstating outcomes or hiding negative ones of which the public is unaware so as to protect its members and revenue base rather than correctly reporting the results.

It is true that the current system of accreditation governing access to Title IV dollars works in this fashion. But it is also true that accreditation did not begin as a way to protect the public interest. Instead, today's accrediting organizations trace their roots to the late 1800s and early 1900s. They arose as a way to protect their members' interests--be that from undue government regulation and influence and/or providing basic self-regulation among the members. It was not until the 1970s that the current system of student-centered, grant- and loan-based financial aid existed. Rather than build its own system of evaluation and oversight, the federal government tied federal aid to accreditation.[3] In doing so, it created both a conflict of interest and a tension that persists to the present day, as can be seen in the accreditors' difficulty with stripping accreditation from institutions. As stated, a new QAE function that focuses on the outcomes an institution claims should work to mitigate opportunities for conflict of interest in fact and appearance; it also prevents repeating an error-prone history. The current accreditation system can continue to provide valuable services to its members and, as with an entity that provides other non-audit services to an institution or a lender, prepare them for their evaluations. Accreditors should not, however, play a role as the final assessor of an educational program's claims around outcomes.

Familial Ties

The members of the entity evaluating the program must not have close familial ties to that program. In practice, this means that a spouse or spousal equivalent, child, dependent, or parent should not be employed, applying for employment, enrolled, or applying for enrollment at the program. The reason is that the familial interest creates an opportunity where the potential for economic loss could interfere with a QAE's thorough review.

Other interests

There are two other economic interests that would undermine an entity's actual or appeared independence.

First, the employees of the entity evaluating the educational program must not accept gifts from the program it is evaluating outside of the normal compensation to the firm, which itself should not contain incentives based on the outcomes of the audit. A QAE's independence would not be impaired so long as the recipient disposes (without financial gain) of the gift or other interest as soon as is

[3] For a brief history of an accreditor to understand how the current system developed, see Kevin Carey, "Accreditation," AEI, Nov. 17, 2009, http://www.aei.org/wp-content/uploads/2011/10/Accreditation%20-%20Kevin%20Carey.pdf.

practicable--meaning when the the recipient has knowledge of the gift or other interest and the right to dispose of it.

Second, the entity must not use its position as evaluator of a program to influence a program to enter into another relationship with an organization in which it has a financial interest, as that would create a similar conflict to the aforementioned direct interest and vendor conflicts.

Key Principle 2: The program being evaluated must not be in a position to exercise undue influence on the entity evaluating it.

The principle ensures that the QAE is independent of the educational program in fact and appearance, even if there are not clear and questionable economic ties that would place the QAE in a conflicted position.

Past Employer Relationship
The QAE must not evaluate a program in which one of its former employees or stakeholders accepts employment *and* that employee is in a position to influence the QAE's recommendations or that employee has a continuing economic interest in the QAE.

Rotating QAEs
An entity must not evaluate the same program for more than five years in a row. After evaluating a program for five consecutive years, it must take a five year hiatus, or time-out period, before it is eligible to audit that program again.

This recommendation brings the quality assurance function in line with the regulations of Sarbanes-Oxley, which specifies that:

> It shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the 5 previous fiscal years of that issuer.[4]

This partner rotation has long been a staple of quality control processes in auditing and prevents a QAE from being too economically reliant on the success of a given partner.

Key Principle 3: The entity that evaluates an educational program's claims around outcomes must take economic risk in excess of the cost of the expected audit revenue.

To give the proposed principles some teeth and create an environment in which students and families have faith in the outcomes reported by educational programs, there should be a body that is able to sanction QAEs that violate these principles or are found to be engaged in other wrongdoing, such that the

[4] http://www.sec.gov/rules/final/33-8183.htm

QAE is more concerned about the impact of performing a poor audit than it is about losing future audit revenue.

For example, in the world of auditing financial statements, the Public Company Accounting Oversight Board (PCAOB) “has the authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes-Oxley Act of 2002, the rules of the PCAOB and the Securities and Exchange Commission, and other laws, rules, and professional standards governing the audits of public companies, brokers, and dealers. When violations are found, the PCAOB can impose appropriate sanctions.” These sanctions can include “censure, monetary penalties, revocation of a firm's registration, and a bar on an individual's association with registered accounting firms.”[5]

Given the quasi-regulatory role that the PCAOB plays, having a non-profit play a similar role for QAEs and the associated standards would seem to be a logical fit.

Conclusion

As we venture into a new world of monitoring the reported outcomes of different education providers with different goals and missions for a diverse array of students, the structures and incentives established will have a meaningful impact on the resulting picture. Experimentation and iteration is critical. Although we cannot anticipate all the possible unintended effects of the new postsecondary education venture, thinking through the possible conflicts of interest ahead of time and creating reasonable structures and requirements that prevent possibly foreseen egregious oversights is critically important in the early going.

Although we don’t suggest we have thoroughly and correctly captured every eventuality, potential conflict of interest, or recommendation, we hope this document serves as both a baseline of thinking and a springboard for productive conversations. Our goal is simple: effectively understand and manage the conflicts of interest inherent in a QAE world so that the experimentation can move forward in a productive manner.

The establishment of the QAE role represents an exciting opportunity to begin transforming the evaluation of “quality” in higher education away from inputs and towards outcomes. If undertaken correctly, this should encourage institutions’ innovation related to boosting student success. As such, we must proceed in a prudent manner and seize that opportunity.

[5] Public Company Accounting Oversight Board, Enforcement, http://pcaobus.org/Enforcement/Pages/default.aspx, accessed May 12, 2016.