

Increased Motivation for Whistleblowing

New statutory and regulatory changes provide greater rewards to individuals who blow the whistle on fraudulent activities and to organizations that actively encourage an effective ethical culture—important steps at a time when the rate of fraudulent financial activity is likely to increase.

The current economic climate has greatly helped to create and sustain an environment conducive to fraudulent financial reporting. As part of its emphasis on enforcement and investor protection, the Securities & Exchange Commission (SEC) has reported a significant increase in 2010 in both the number and the size of fraud cases. The agency even formed an Investor Advisory Committee in 2009.

Now, provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA), e.g., Title IX—Investor Protection and Securities Reform Act of 2010, and new incentives contained in amendments to the U.S. Federal Sentencing Guidelines are likely to increase the motivation for whistleblowing activities and subsequent assertions of fraud.

The probability of wrongdoing is likely to increase. According to the *2010 Ethics & Workplace*

Survey published by Deloitte, one reason is that the economic downturn has diminished two important elements of conducting business: trust and ethics. Nearly a third of employees surveyed said their fellow workers are more likely to behave in an unethical manner in today's environment. The report noted that almost half of employees who planned to search for new employment when the job market recovers stated that one of their reasons for leaving was a loss of trust in their employer because of how decisions were made.

These factors will likely contribute to more instances of fraudulent financial reporting. More than half the respondents to a webcast poll conducted by Deloitte think more financial statement fraud will be uncovered in 2010 and 2011 compared to the past, and 45% believe fraud is getting harder to detect because of changes in the risk environment. Manipulation of revenue recognition was cited as the greatest concern, followed by “big-bath” write-offs while earnings expectations are low and manipulation for debt covenant compliance purposes.

As reported regularly in the biannual *Report to the Nations on Occupational Fraud and Abuse*

from the Association of Certified Fraud Examiners (ACFE), the most fruitful source of information leading to discovery of fraudulent activity is whistleblowing tips from employees or outsiders. Having an anonymous method to report wrongdoing has significant benefits, according to the ACFE, including quicker discovery, shorter duration, and smaller losses.

While the term “whistleblowing” can mean different things to different people and in differing environments, Brian Martin, a professor at the University of Wollongong in Australia and author of *The Whistleblower's Handbook: How to Be an Effective Resister*, has widely publicized a definition of whistleblowing:

“Whistleblowing is an open disclosure about significant wrongdoing made by a concerned citizen totally or predominantly motivated by notions of public interest, who has perceived the wrongdoing in a particular role and initiates the disclosure of her or his own free will, to a person or agency capable of investigating the complaint and facilitating the correction of wrongdoing.”

It should be noted that only disclosures of “significant” wrongdoing should be considered whistle-

blowing, not legitimate differences of opinion or minor concerns. Also important is that the motivation for disclosure shouldn't be personal but should reflect the interests of a larger public. The language describing the whistleblower as a concerned citizen reflects the fact that issues of whistleblowing in the past were largely limited to the government sector, including lawsuits under the False Claims, or *qui tam*, statutes.

A more legalistic definition of whistleblowers is contained in *Whistleblowing: The Law of Retaliatory Discharge* by Daniel Westman and Nancy Modesitt: "Employees who oppose, either internally or externally, their employer's conduct." Employee opposition may be based on a number of grounds, including the belief that the employer's conduct is unethical, dangerous, or illegal. Westman and Modesitt list four categories of whistleblower: passive, active-internal, active-external, and embryonic.

The Dodd-Frank Act

The most important whistleblower motivator is the authority granted to the SEC for making bounty payments to whistleblowers. The new authority granted by the Dodd-Frank Act is broad and comprehensive. Awards can range from 10%-30% of the amount of monetary sanctions in cases over \$1 million, including penalties and interest as well as disgorgement. Information provided to the SEC must be "original" and derived from the whistleblower's independent knowledge or analysis and not known to the SEC from any other source. For example, Harry Markopolis, the Madoff whistleblower shunned several

times by the SEC, could have been eligible for billions in bounties under the new plan. Awards aren't limited to employees and can include vendors and others.

Similar provisions cover whistleblowers who report information about wrongdoing elsewhere, such as whistleblowing reporting about fraudulent derivatives to the Commodity Futures Trading Commission. Interestingly, a section of DFA dealing with consumer protection adds protection for whistleblowers in the financial services industry who disclose information about companies that extend consumer credit, provide real estate or appraisal services, or provide financial advisory services to consumers. The breadth of the scope of the new consumer protection agency is impressive and will encompass dealing with a great many retail and other consumer-oriented establishments.

DFA also provides significantly greater employment protection to employee whistleblowers than the Sarbanes-Oxley Act (SOX) does. DFA specifically covers retaliation resulting from information given to a supervisor or audit committee, and it allows for recovery of

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double back pay, not just reinstatement of employment. Jury trials are available, and cases can't be subject to mandatory predispute arbitration. The statute of limitations for whistleblowing has been extended to six years after the unlawful action took place. Many of the provisions of DFA require the writing of implementing regulations. The deadline for the regulations for whistleblowing bounties is April 2011.

Sentencing Guidelines

The amendment to the U.S. Sentencing Commission guidelines for organizations uses the potential of sentence mitigation to encourage companies to adopt a structure that gives compliance and ethics officers direct-reporting obligations to an organization's governing authority. The amendment also clarifies the remediation efforts that an effective compliance and ethics program is required to have. It describes the reasonable steps that an organization should take—including the employment of an independent monitor—in order to respond appropriately after criminal conduct is detected and to prevent further similar criminal conduct. The amendment also specifies direct-reporting obligations from the head of the compliance program to the board of directors or audit committee, including reporting "no less than annually on the implementation and effectiveness of the compliance and ethics program."

Rewarding Proper Behavior

Actions that should be taken in response to the new legislative and

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regulatory mandates are many and basically involve assuring the effectiveness of an organization's ethics and compliance program. The new potential financial rewards may greatly motivate employees to bypass reporting wrongdoing internally as required today by most organizations and as set forth in the *IMA Statement of Ethical Professional Practice*. While potentially financially attractive to the whistleblower, reporting externally poses significant monetary risks to the organization, including high legal costs and loss of reputation.

Some observers believe that, to counteract this tendency, rewards of a financial nature, not just verbal recognition, should be awarded to those who follow the rules and utilize internal reporting structures. They believe that it may be necessary to give money to internal reporters of wrongdoing so that organizations can compete effectively with the SEC's offer to share the fruits of a massive investigation. Of course, such internal whistleblowers would have to forgo anonymity and rely on the organization to retain their employment (backed up by the new antiretaliation provisions of DFA).

The SEC and the Sentencing Guidelines both provide mitigation of otherwise-assessable sanctions for cooperative behavior when wrongdoing is disclosed by the organization. This is another benefit of having an ethical culture that fosters an attitude where employees aren't afraid to speak up when they know something that could hurt the organization. **SF**

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