

Creating An Effective Whistleblowing Environment

By Jason MacGregor, Michael Robinson, and Martin Stuebs

From Enron to Bernie Madoff, a steady stream of fraud in companies of all sizes and from all industries has marked corporate America in recent years. Beyond the direct costs associated with fraud, these crimes damage public trust and undermine shareholder confidence in the market.

In an effort to strengthen regulatory and corporate governance mechanisms in order to limit the potential losses associated with fraud and restore investor confidence, the U.S. government responded with legislative actions such as the Sarbanes-Oxley Act of 2002 (SOX) and the Dodd-Frank Wall Street Reform and Consumer Protection Act. Whistleblowing is central to these legislative reforms and remains the most common, effective way to detect fraud. Dodd-Frank even mandates that all public companies have whistleblowing programs.

This means companies are no longer faced with the question of whether or not to have a whistleblowing program but with how to best implement and manage an effective whistleblowing program. From the employee perspective, witnessing a wrongful act isn't always enough to turn someone into a whistleblower. Many witnesses choose to keep silent about any wrongdoing they may have seen or encountered evidence of during the course of their job. Companies thus need to understand what they can do to influence an individual's decision to blow the whistle and apply that understanding to develop an effective system of whistleblowing procedures.

Establishing Effective Whistleblowing Procedures

On a fundamental level, the whistleblower is simply an individual making a reporting decision. Figure 1 shows a general reporting environment model involving three parties: the reporter, the reportee, and report users. In the general reporting process, the reporter assesses the performance of the reportee and issues a report. Based on information in that report, the report users analyze the reportee's performance and make decisions. In writing the report, the reporter decides what information is gathered and how it is communicated. Both report users and reportees rely on the reporter to report trustworthy, accurate, and useful information.

In the whistleblowing environment, the reporter is the whistleblower, the reportee is an individual or group

committing an alleged wrongdoing, and the report user is an authority of some kind. Technically, this authority can be someone outside the organization, but we focus on internal reporting as it is more relevant for companies aiming to implement a program. Within an organization, the whistleblower should report the information to an authority such as a supervisor, the internal auditors, and/or the audit committee.

This discussion shows that an effective whistleblowing environment depends not only on the actions of the whistleblower, who observes or detects wrongdoing and issues a report, but also the authority figure who receives the report. Understanding this from an organizational perspective is a critical issue when trying to design, implement, and manage effective whistleblowing procedures.

Whistleblowers typically aren't trained reporting professionals, and they're often novices compelled by circumstances to serve as reporters. Therefore, it's important to have procedures in place that will motivate witnesses of wrongdoing to blow the whistle. Based on James Rest's model of ethical decision making as well as research on internal controls, we believe there are four pillars of a successful whistleblowing environment: (1) hire and develop potential whistleblowers, (2) educate employees, (3) promote reporting of wrongdoing, and (4) analyze and respond appropriately to all reports (see Figure 2). A weakness in any pillar reduces the effectiveness of the entire system.

Figure 1: The General Reporting Environment

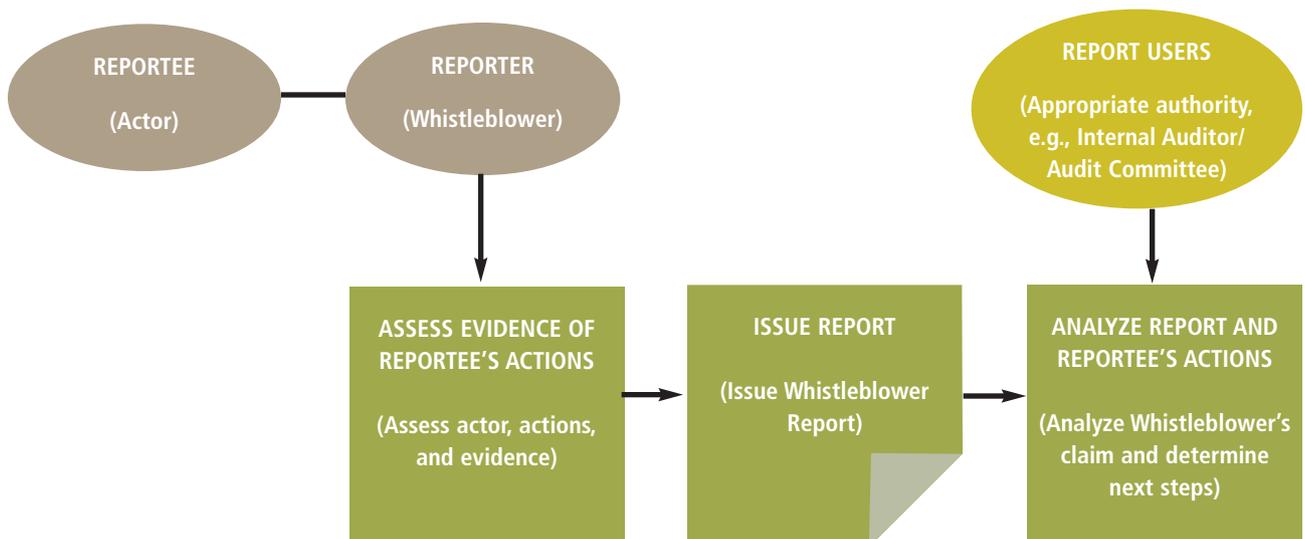


Figure 2: The Four Pillars of an Effective Whistleblowing Environment



Pillar 1: Hire and Develop Potential Whistleblowers

An effective whistleblowing environment must begin with employees who are open to the possibility of reporting what they witness. Employees who are more likely to blow the whistle when they detect wrongdoing are marked by (1) greater awareness of the opportunities for wrongdoing in their organizations, (2) stronger connection to the organization, (3) a stronger professional identity, and (4) a stronger moral character relative to nonwhistleblowers. There are several ways you can help build a workforce of potential whistleblowers.

Hire the Right People. In the hiring process, be attentive to evidence about a candidate’s character and professional identity. For example, consider whether job candidates belong to any professional organization (and encourage current employees to be active members within their professional communities). If the position has direct influence over the reporting process, discuss the candidate’s beliefs regarding ethics and under what circumstances he or she would consider blowing the whistle.

Foster Organizational Commitment. Create and maintain an organizational culture that nurtures loyalty to the organization. Simple measures such as providing corporate clothing and corporate-branded office supplies have been found to be effective at increasing organizational identification. Also, providing compensation that’s both equitable within the company and comparable to peer organizations helps increase corporate loyalty. Last, it’s vital that the company maintains a high level of organizational justice by ensuring all conflicts are resolved equitably, the annual review process is fair and transparent, and company policies are followed judiciously.

Make Ethics a Priority. Make it clear that employees are expected to act with integrity. Employ training that outlines management’s ethical expectations while instilling the confidence required to make tough ethical decisions. Leaders do this by setting a tone at the top marked by high ethical standards, demonstrating integrity in decision making, and praising ethical actions while privately correcting unethical choices.

Pillar 2: Educate Employees

Whistleblowers can act only when they are able to recognize wrongdoing, understand their responsibility to report it, and know how to communicate the concern properly. Organizations can take several steps to educate their employees and turn them into potential whistleblowers.

Explain the Purpose of Whistleblowing

Procedures. Employees need to understand why the organization needs a whistleblowing program. It's similar to why a private company chooses to pay for an external audit in order to establish that the management and its reports are trustworthy. With the proper education of employees, the whistleblowing program should increase the level of trust within the organization in at least two ways. First, those in a position to blow the whistle will have greater reason to trust that they will be protected from reprisals for doing so. Second, employees will have greater trust that they won't be punished for baseless charges.

Education can ease concerns that employees are working in an environment in which their peers are watching their every move in order to detect wrongdoing, which can lead to an environment of paranoia and distrust. Instead, employees will understand that individuals who become whistleblowers are ethical people who acted on their obligation to report wrongdoing that they observed during the normal course of business—not that they went out of their way searching for evidence of wrongdoing.

Clarify the Breadth of Whistleblowing Issues.

Communicate the types of wrongdoing that warrant whistleblowing. Defining the spectrum of issues can increase attentiveness to wrongdoing. Consider three scenarios:

1. While there's no question that employees who accept kickbacks from suppliers should be reported, many employees may wonder if they need to report a coworker who accepts small gifts or a lunch from a supplier.
2. An employee who leaves work early for a personal lunch likely doesn't warrant reporting, but one who expenses his personal lunch probably does.
3. A supervisor who dismisses a single study that suggests a minor safety problem with a product likely doesn't need to be reported, but one who ignores the serious negative implications of several studies may warrant blowing the whistle.

This communication should be done not only during new employee orientation but also periodically thereafter.

A variety of techniques can reinforce this message, such as e-mailing to employees some YouTube-style videos related to ethical responsibilities or bringing in a special speaker to discuss the importance of blowing the whistle.

Failure to remind employees about the types of issues that should be reported can be seen in the case of David Myers at WorldCom. Myers was an experienced accountant who joined WorldCom in 1995 as treasurer. When Myers presented quarterly financials in 1999 that failed to meet analysts' forecasts, he was instructed by his boss, WorldCom CFO Scott Sullivan, to find his "mistake." After redoing and presenting similar financials, Myers again was told to find his mistake. The company released reserves to close the difference between what Myers was reporting and what Sullivan thought the numbers needed to be.

Instead of blowing the whistle, Myers remained silent. His alleged "error" was never found, and the release of reserves was repeated again and again to "correct" other errors. Myers believed he had to protect the jobs of WorldCom employees by allowing these unethical accounting treatments. What began as a seemingly simple accounting adjustment escalated into one of the largest frauds in business history.

Establish Whistleblowing Responsibilities.

Employees need to know that everyone is obligated to blow the whistle and will face consequences for failing to report a wrongful act. For example, if an employee observes a wrong act and doesn't report it, will that person be terminated or face lesser penalties? If there are no consequences, that employee may question whether there truly is a responsibility to report.

Periodically highlighting the importance of whistleblowing can reinforce these reporting responsibilities. For example, management can share news stories by e-mail of cases in which unreported fraud led to organizational failure or reported fraud led to organizational success. In the unfortunate event that fraud occurs in the company and disciplinary action is taken against an individual for remaining silent, it's critical that this event be communicated to all employees in order to discourage others from turning a blind eye.

In addition, part of the whistleblower's responsibility is to provide a truthful report. There must be a "good-faith" requirement to protect employees from false accusations and avoid spending organizational resources investigating false leads. If an employee knowingly provides a false report, then appropriate disciplinary action should be taken.



Communicate Reporting Options. Potential whistleblowers must be taught how to communicate their concerns appropriately. Specifically, it's essential that employees understand to whom they should talk about their concerns. If they go to the wrong individual, an appropriate investigation may not be triggered and the whistleblower may not be protected from retribution.

Larger organizations should consider whether a tiered reporting system is appropriate. For example, in an initial tier, employees can raise concerns to their immediate supervisor. This informal communication may facilitate a more expedient investigation. A second tier could involve reporting concerns to upper management or the board of directors, which could trigger a more formal investigation. A final tier is outside reporting. Although it isn't necessarily optimal, employees should be aware of the option to report to regulators such as the Internal Revenue Service (IRS) or U.S. Securities & Exchange Commission (SEC). The *IMA Statement of Ethical Professional Practice* explicitly provides a detailed example of tiered procedures for the resolution of ethical conflict.

Employees also should be instructed on how to communicate their concerns, such as through face-to-face reporting, whistleblowing hotlines, Internet-based reporting, or comment boxes. The organization must decide whether it's economical to manage these functions in-house or to outsource them. For example, some accounting firms have developed whistleblowing hotlines as a business-to-business service.

It's also necessary to consider personal identification policies that protect the whistleblower's identity by facilitating confidential or anonymous reporting. Confidential reporting is advantageous because it may lessen the social cost of reporting, but it does create an environment in which employees and their supervisors may need to

deceive others in order to protect confidentiality. Furthermore, maintaining confidentiality actually may hinder the investigation because it reduces transparency. Each organization must determine the strategy that works best for its own program and communicate that to employees.

Provide Awareness of Independent Advice. Providing independent confidential advice to prospective whistleblowers reduces the risk that a misunderstanding of whistleblowing procedures will result in a fraud going unreported. For example, an organization can maintain an active omnibus program or provide access to a legal-advice hotline. Employees periodically need to be reminded that this independent option is available.

They also should be encouraged to use it in case they are uncertain if something warrants reporting or if they're nervous about bringing it to a superior without support. For example, the reporting decision may be blurred by ambiguous statements. A supervisor who instructs the bookkeeper to record an inappropriate transaction clearly needs to be reported, but when a supervisor asks the bookkeeper to use an aggressive estimate or to "find a way," this request may not warrant a report. In this setting, an independent advisor can help provide guidance and potentially avoid a formal investigation.

Pillar 3: Promote Reporting

After assessing the evidence, the prospective whistleblower must decide whether to report the wrongful act. To promote reporting, an organization should provide rewards and safeguards to whistleblowers.

Provide Adequate Rewards. Because whistleblowers frequently incur significant social costs for reporting on their peers, provide incentives to employees who report wrongdoing. To avoid confusion, it should be clearly specified how rewards are determined, including the context and conditions for reward. For example, the reward can be a fixed amount or a percentage of the size of fraud uncovered. The conditions that need to be met to merit a reward should also be outlined. They may include criminal conviction of the wrongdoer, criminal prosecution of the wrongdoer, or simply an organizational finding that wrongdoing has occurred.

Institute Safeguards. An effective whistleblowing program needs to provide adequate protection of whistleblowers so that employees aren't deterred by fear of reprisal. Whereas the most common safeguard is assurance that the whistleblower won't be fired, the organization also can provide transfer to another business unit at the same level, an extended paid leave for training to

facilitate transfer to a new position, or an appropriate severance package if the employee finds the working environment to be hostile after blowing the whistle.

Employees must also be protected from false accusations. Such protection may involve working with labor unions and other stakeholders to assure that all employees' rights are protected. Also, policies should specify requirements for corroboration of accusations and provide a protocol for bringing in outside assistance for accused employees when such assistance is requested.

Pillar 4: Analyze and Respond to All Reports

The effectiveness of the whistleblowing process depends on an appropriate analysis and response by those who receive the report of wrongdoing. The process requires both formal procedures and adequate resources to ensure that every claim is addressed appropriately.

Follow Established Investigation Procedures.

Clear procedures on how to respond to a report of wrongdoing must be established prior to any investigation. Auditors, audit committee members, or Certified Fraud Examiners (CFEs) can be useful resources to help develop these procedures. The key parties of the investigation should be specified, including who is responsible for documenting the whistleblower's accusation, for deciding whether to investigate the accusation, for conducting the investigation, and for recommending the appropriate response.

For these procedures to be effective, the investigators must be properly trained in how to implement them. This training may consist of investigators attending workshops or webinars hosted by professional associations (e.g., the KPMG Audit Committee Institute). Also, the organization may periodically bring in an expert to provide training to managers, internal auditors, and board members.

Provide Sufficient Investigation Resources.

Resources are needed to investigate claims of wrongdoing and pay any reward to the whistleblower. Investigators should have access to the internal auditor and relevant department heads in order to collect evidence. They also may need the financial resources to hire outside legal counsel, CFEs, or other specialists to help investigate the report. Consider establishing an investigation fund to ensure that monetary resources are always available.

Resolve the Matter. Once the investigation is concluded, there needs to be some sort of resolution of the matter. This can vary from terminating the accused to

taking no action against him or her. Resolution includes communicating the conclusions of the investigation to both the accused and the whistleblower and reviewing the investigation to verify that all specified whistleblowing procedures were followed. This review is important even when the investigators conclude no action is required. There's a significant difference between (1) concluding there was insufficient evidence to take action against the accused and (2) finding sufficient evidence that nothing wrong occurred.

Finally, all reports and responses must be documented. This may involve removing names from the records to protect individuals who were falsely accused. These records may play a vital role in future investigations and can serve as a deterrent against future wrongdoing.

More Than a Program

Whistleblowing isn't just a program. It is an organizational mind-set that holds employees accountable for their actions and makes everyone in the organization responsible for reporting wrongdoing. This mind-set begins by hiring employees who will carry out their whistleblowing responsibilities, and it's reinforced through education and the action of management. The whistleblowing mind-set compels employees to report any wrongdoing they see and assures that all reports are resolved appropriately.

In the long run, whistleblowing requires constant monitoring or the procedures will become outdated or forgotten. Because every organization is susceptible to fraud, every organization needs to actively examine its whistleblowing procedures to minimize the risk that wrongdoing will go unreported. **SF**

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