

**RESEARCH ON PROFESSIONAL
RESPONSIBILITY AND ETHICS
IN ACCOUNTING**

RESEARCH ON PROFESSIONAL RESPONSIBILITY AND ETHICS IN ACCOUNTING

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RESEARCH ON PROFESSIONAL RESPONSIBILITY
AND ETHICS IN ACCOUNTING VOLUME 22

RESEARCH ON PROFESSIONAL RESPONSIBILITY AND ETHICS IN ACCOUNTING

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CHAPTER 1

MAKING CRIME PAY: TIMING OF EXTERNAL WHISTLEBLOWING

Andrea M. Scheetz and Joseph Wall

ABSTRACT

With the increasing prevalence of awards for reporting fraudulent activity, it is important to learn if there are unintended consequences associated with the language offering such awards. Aside from issues regarding submitting unsubstantiated claims of fraud to the Securities and Exchange Commission (SEC), Section 922 of the Dodd–Frank Act may inadvertently encourage would-be whistleblowers to delay reporting fraud. Potential whistleblowers may choose to delay reporting due to the consideration of alternatives to external reporting, in a misguided attempt to increase the size of an award, or due to their ethical stance on the issues. Using a three-stage mixed methods (experiment, open-ended interviews, and experiment) approach, this study provides evidence that increased knowledge of statutes involving external whistleblowing may result in reporting delays. The data suggest that despite statements from the SEC forbidding this, managers may choose to delay reporting when under the threshold necessary to receive an award. In such a manner, managers may be allowing the fraud to grow to a necessary perceived level over time. As might be expected, the accountants in this study were more cautious, checking to see if internal reporting worked first. Of particular note, 16 individuals indicated that they would never report, with the motivation apparently driven by fear of job loss and/or retaliation. Lastly, the intention to delay or speed up reporting may be very different based on the perception of ethics involved in the decision.

Keywords: The Dodd–Frank Act; whistleblowing; fraud; reporting; wrongdoing; fraud materiality

INTRODUCTION

This study examines the impact of knowledge and understanding of statutes involving external whistleblowing on the timing of when, following the discovery of fraud, employees choose to report fraud externally. The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) provides an ideal conduit for this study due to the whistleblowing provisions of the Act allowing for rewards, under certain circumstances, when fraud is reported to the Securities and Exchange Commission (SEC). The [Association of Certified Fraud Examiners \(ACFE, 2018\)](#) has reported an increase in fraud cases. Likewise, the report commissioned by [Kroll \(2017\)](#) has also reported an increase in fraud incidents. The ACFE's 2018 *Report to the Nations* is based on the 2017 Global Fraud Survey of Certified Fraud Examiners. The ACFE (2018) reports 2,690 incidents of fraud occurring between January 2016 and late 2017. This represents an increase from the 2016 and 2014 Global Fraud Surveys which reported 2,410 and 1,483 incidents of fraud, respectively (ACFE, 2014, 2016). Kroll's *Global Fraud & Risk Report*¹ found that companies reporting at least one incidence of fraud rose to 82%, up from 75% in 2015 (70% in 2013 and 61% in 2012).

The aforementioned fraud statistics are somewhat counterintuitive following the enactment of legislation designed to put the public's mind at ease when it comes to large-scale fraud. Section 922 of Dodd–Frank established the Securities and Exchange Commission's Office of the Whistleblower (OWB) and the Investor Protection Fund (SEC, 2017). This program incentivizes individuals to report information about securities laws violations in a timely manner. In 2017, the OWB received over 4,400 tips, which represents a 50% increase in tips from 2012, and paid out over \$50 million in awards to 12 whistleblowers (SEC, 2017).

Further, the *2017 Annual Report to Congress on the Dodd–Frank Whistleblower Program* (SEC, 2017) shows a general uptrend in award size as more fraud is uncovered and related actions are successful. However, despite the enormous number of tips, the quantity of awards granted annually tends to be rather low. Since the inception of the program in 2011 there have been 46 whistleblowers who received awards totaling about \$160 million (SEC, 2017). This results in an average of only 6–7 whistleblowers receiving awards each year. The SEC specifically noted that the two largest awards to date (\$83 million split between three whistleblowers in 2018 and \$30 million paid to one whistleblower in 2014) were smaller than they would have been otherwise without unreasonable reporting delays to the Commission (SEC, 2014, 2018).

The Act itself fails to allude to any time limitations on making whistleblowing reports, although the commission may consider “additional relevant factors” when determining the award amount ([U.S. House of Representatives, 2010](#)). The whistleblowing provisions provided in Dodd–Frank assumed that individual reports of securities law violations would be made rather quickly. Yet, this assumption was not tested before Dodd–Frank was implemented. The more recent SEC reports made to congress (SEC 2015, 2016, 2017) about the whistleblower program now include factors that would decrease a whistleblower's award.

Although the law was designed to hasten action from people interested in monetary rewards, among others, might it be influencing some to actually delay their reporting? Perhaps this is why the SEC is now more explicit about how awards are determined.

Factors that may decrease an award percentage include whether the whistleblower was culpable or involved in the underlying misconduct, interfered with internal compliance systems, or unreasonably delayed in reporting the violation to the Commission. (SEC, 2017)

Thus, even though the intent of the Act was clear, we wonder if there might be unanticipated consequences to when fraud reports are made. Because anyone in a white-collar setting might encounter fraud, or discussions of the type of fraud typically disclosed externally, we first ran an experiment on the white-collar business community. In the first experiment, this study tests the impact of Dodd–Frank on whistleblowing intentions on office workers and managers when the fraud itself is above and below the monetary sanction threshold to become eligible for a whistleblower award. Because the awareness of Dodd–Frank appeared to increase the intention of the participants to delay, we then conducted a series of open-ended interviews. We discovered that there appeared to be confusion about whether the amount of the fraud or the amount of the sanctions determined awards, even when presented with the whistleblowing provision from Dodd–Frank. Finally, we conducted a second experiment on the accounting community. As accountants are likely to be familiar with Dodd–Frank, and accountants are increasingly likely to detect the type of fraud, which might be reported, we tested the effect of providing clarifying information about the whistleblowing provisions within Dodd–Frank on the intention to report. This helps determine if the delay intention also held true when accountants were succinctly reminded of the whistleblowing provisions of Dodd–Frank.

This study investigates the influence of Dodd–Frank on the timing intentions of reporting this fraud externally. The study further examines the influence of the \$1,000,000 Dodd–Frank award trigger threshold for monetary award eligibility on these timing intentions. This study primarily examines the effect upon external reporting rather than internal reporting to focus on the intentions of the Act. Additionally, because the internal reporting policies at each firm will likely differ substantially, participants may carry biases unknown to them into the experiment regarding their internal controls. However, the accountants in experiment two were also asked where they would report first and interesting results follow. The results indicate understanding of the Dodd–Frank Act influences when individuals choose to report fraud.

This study contributes to the whistleblowing research by examining the timing of intentions to report fraud. Given the new regulatory environment under Dodd–Frank, little research exists in the intervening years related to external whistleblowing. To date, no studies examine the interaction between fraud materiality and knowledge of Dodd–Frank in an environment where awards grow as the fraud grows. Additionally, within whistleblowing literature, few studies explore the gap between perceived regulatory knowledge and anti-regulatory behavior. Therefore, this study contributes to whistleblowing literature in meaningful ways.

So informed, organizations can create more effective whistleblower policies and the SEC can consider actions to discourage delayed reporting.

The next section briefly discusses the background literature and develops hypotheses investigated in this study. Following this is a discussion of the experimental method and a presentation of the results. Finally, the paper concludes with a discussion of the results, contributions, limitations, and avenues for future research.

LITERATURE REVIEW

Fraud

Fraud in accounting literature, sets its roots in the Fraud Triangle (Cressey, 1953), which suggests opportunity, pressure, and rationalization need simultaneously be present in order for fraud to be committed. From this simple triangle, meta-models (Dorminey, Fleming, Kranacher, & Riley, 2012) have evolved, attempting to expand and widen its reach to the point where some question if it has become too generalizable and unverified down many paths (Morales, Gendron, & Guénin-Paracini, 2014). Instead of a myopic focus on the triangle, it is argued, perhaps literature would be better served attempting to deconstruct fraud on the basis of capability (Wolfe & Hermanson, 2004), decision-making models (Lokanan, 2015), or other measures. Indeed, one such call to action suggests that collusive fraud is on the rise (Free & Murphy, 2015) and studies involving additional fraud actors or alternative points of view are needed. Given that a potential whistleblower who chooses to say nothing colludes at least indirectly, studies involving whistleblowing intent appear to match this call well.

Whistleblowing and Dodd–Frank Provisions

Dodd–Frank defines a whistleblower as an individual “who provides information relating to a violation of” the securities laws to the SEC (U.S. House of Representatives, 2010). More generally, whistleblowing is the disclosure of “illegal, immoral, or illegitimate practices” that allows action to be taken (Miceli & Near, 1992). Section 922 of the Dodd–Frank Act set up the OWB (2018), which has been “authorized by Congress to provide monetary awards to eligible individuals who come forward with high-quality original information that leads to a Commission enforcement action.”

To be eligible for an award the SEC judicial or administrative action must have been successful and the monetary sanctions must exceed \$1 million. Monetary sanctions include penalties, disgorgement, and interest that the SEC orders to be paid (U.S. House of Representatives, 2010). The courts can require both civil penalties as well as disgorgement for violating SEC regulations. Civil penalties are punitive in nature, whereas disgorgement is the repayment of gains received through illegal or unethical transactions. Awards granted for providing original information range from 10% to 30% of the collected monetary sanctions imposed in the action (U.S. House of Representatives, 2010). Courts arrive at the total

monetary sanction dollar amount inconsistently. This makes it difficult for individuals to estimate if the fraud they discovered exceeds the \$1 million sanction threshold for an award. It is likely that potential whistleblowers use the actual dollar amount of the fraud as a basis. This study operationalizes monetary sanctions in a similar manner, and makes no mention of penalties or interest related to the fraud.

Since the inception of the OWB, over 22,000 tips have been received, the SEC has ordered more than \$975 million in financial sanctions, and 46 whistleblowers have received over \$160 million in awards (SEC, 2017). The largest award, announced in March 2018, was over \$83 million, with \$50 million split between two whistleblowers and \$33 million going to a third whistleblower (SEC, 2018). It can take several years for an SEC investigation to take place (SEC, 2017) and for the whistleblower award approval. However, payments have been made in six months. The relative newness of the program (first operational in August 2011), combined with the time it takes for a complex SEC investigation, may be why so few awards exist. As for the \$83 million awarded in 2018 and the \$30 million in 2014, the SEC noted in both cases that the awards would have been even higher, but the tipsters chose to unreasonably delay reporting the misconduct upon discovery (SEC, 2014, 2018). This decision provided some clarification to what the SEC considers “additional relevant factors” when determining the size of a whistleblowing award. The SEC’s response to the whistleblower’s delayed report was an early indication that delayed reporting has the potential to diminish award size, should the SEC have evidence of when the whistleblower first discovered the fraud.

The government understands the benefits of providing whistleblower awards to incentivize individuals to report fraud. The False Claims Act instituted penalties for individuals submitting false claims (i.e., defrauding) to the government and awards for the individuals who bring suit (bring a qui tam action) on behalf of the government (U.S. Department of Justice (DOJ), 2011). The changes made in 1986 increased whistleblower incentives, which led to more investigations. In 2017, \$392 million was paid to whistleblowers under the False Claims Act based on \$3.4 billion in settlements filed under qui tam provisions (DOJ, 2017). Additionally, the IRS also uses whistleblower informant awards to encourage individuals to report tax evasion. The Tax Relief and Health Care Act of 2006 established the Whistleblower Office within the IRS and stated that whistleblowers would be paid 15–30% of the amounts collected by the IRS in tax and penalties (IRS Whistleblower Office, 2017). Since the inception of the program in 2007 through 2017, more than \$499 million has been awarded to whistleblowers based on a collection of more than \$3.6 billion in taxes, penalties, and interest (IRS, 2017). In 2017 alone the IRS made 242 awards for a total of nearly \$34 million (IRS, 2017).

Lastly, without consideration of award, not all ethical dilemmas are equal. As put by Leitsch (2006), most individuals would view stealing office supplies, such as a pen, from one’s place of employment as less unethical than embezzling large amounts of money from that same employer. Jones (1991) theorized that moral intensity, or characteristics specific to the situation, significantly influences

individuals' decision-making processes, and is "likely to vary substantially from issue to issue, with few issues achieving high levels and many issues achieving low levels." Research, which examines the influence of characteristics of wrongdoing, suggests that the type and seriousness of the wrongdoing predisposes people's perceptions of the wrongdoing act (Kaplan & Schultz, 2007; Robinson & Bennett, 1995). This perception then influences reporting intentions and the reporting process (Ayers & Kaplan, 2005; Near, Rehg, VanScotter, & Miceli, 2004).

Whistleblowing Conflict and Delays

The 2016 *Annual Report to Congress on the Dodd–Frank Whistleblower Program* discusses a specific award, which was made to a whistleblower who waited to report the fraud. The proceeding discussion explains the damage that delayed reporting causes.

Unreasonable reporting delay is a negative factor that may decrease an award percentage. The Commission found that the whistleblower's delay, while limited in duration, was unreasonable in light of the incentives and protections now afforded to whistleblowers under the Commission's whistleblower program. Also of significance, the great majority of the total disgorgement ordered in the underlying enforcement matter was attributable to the misconduct that occurred after the whistleblower learned about the misconduct and before reporting the information to the Commission, with a resulting increase in the monetary sanctions upon which the whistleblower's award was based. Delayed reporting is particularly problematic where the securities violations are ongoing and the ill-gotten gains of the wrongdoing increase after the whistleblower has learned of the misconduct and yet delays reporting the activity internally, to another regulator, or to the Commission. Further, delayed reporting can potentially result in wrongdoers squandering ill-gotten gains that belong to investors or other innocent third parties and may negatively impact the commission's ability to prosecute an enforcement action. (SEC, 2016)

The recent economic downturn and financial pressures have led more executives to state that they might be willing to engage in unethical behavior (EY, 2016). EY's 14th *Global Fraud Survey: Corporate Misconduct – Individual Consequences* finds that 42% of surveyed executives indicated that they could justify unethical behavior to meet financial targets (EY, 2016). EY's 18th survey states "The propensity of respondents who would justify fraud to meet financial targets has increased on a global level since 2016" (EY, 2018, p. 8). It concludes financial misstatement is still an issue and reports 14% changing assumptions related to valuations and reserves, 12% extending the monthly reporting period, and 7% backdating contracts (EY, 2018). This sentiment renews the importance of encouraging employees to provide fraud tips in a timely manner. However, concerns exist over the inherent conflict of interest that exists between the potential whistleblower and outside parties (Barthle, 2012).

SEC whistleblowing awards are based on the total monetary sanctions related to the securities laws violations. To be eligible for an award, the violation, interest, penalties, and disgorgement must exceed \$1 million (U.S. House of Representatives, 2010). If the whistleblower waits to report the fraud and the damages increase, the total potential dollar value of their award may increase if this delay is not discovered. This is out of alignment with the intent of the Investor

Protection Fund, designed to incentivize individuals to report fraud quickly (SEC, 2016). Therefore, the materiality of the fraud (being above or below the threshold whereby the individual becomes eligible for an award), knowledge of their eligibility for an award under the Dodd–Frank whistleblowing awards program, and other considerations may impact the timing of an employee's report of fraud to the SEC.

Whistleblowing Awards

Current literature suggests that monetary rewards influence whistleblowing intention (Brink, Lowe, & Victoravich, 2013; Dyck, Morse, & Zingales, 2010; Feldman & Lobel, 2010; Guthrie & Taylor, 2017). Dyck et al. (2010) find that monetary incentives play a significant role in fraud reporting, regardless of the severity of the fraud, and motivates people with information to come forward. Feldman and Lobel (2010) examine the effect of reporting incentives and severity of the illegal act by manipulating the reward amount as either \$1,000 or \$1,000,000 and the severity of the act as high or low. Results indicate that higher rewards and more severe, illegal, and immoral acts increase reporting intention. Further, a higher reward seems to encourage whistleblowing in circumstances, such as low severity, which would generally have lower intentions to report. Brink et al. (2013) find an interaction between the presence of internal reward incentives and evidence strength on intention to whistleblow. Results indicate that when evidence is weak the presence of an internal monetary incentive encourages internal reporting. But, when evidence is strong the same internal incentive encourages external reporting to the SEC, perhaps because participants misunderstand the Act and believed that they were more likely to receive the SEC reward in this scenario.

Although awards may encourage individuals to come forward eventually, how such awards influence when individuals come forward remains undiscovered. The aforementioned programs base the awards paid to whistleblowers on the damages or amounts recovered. Yet, it is impossible to know for sure when these individuals became aware of the wrongdoing. As a result, potential whistleblowers may believe that they have an incentive to wait, regardless of the dollar value of the fraud, when they believe that the fraud will continue undetected.

One such instance of delayed fraud reporting occurred in the early 1990s related to a False Claims Act suit. The whistleblower first contacted his lawyers in 1987 when damages were only \$13.1 million, but did not actually file the qui tam suit until 1990 when damages had increased to \$41.5 million. A settlement was made in 1994 for \$59.5 million, of which the whistleblower received 22.5%, exceeding the total damages of the original fraud in 1987 (Barthle, 2012; U.S. Court of Appeals, 1994). In this instance, the whistleblower was clearly eligible for an award much earlier, but chose to wait to report the fraud.

HYPOTHESES

In order to test whether knowledge of Dodd–Frank or the monetary rewards associated with whistleblowing influence the timing of external reporting, varying

conditions for each must be manipulated. These conditions enable tests of potential behavior resulting in intentions counter to the regulations. We first hypothesize direct effects derived from the literature. We then use these results to ask questions that enhance our understanding. We then ask for additional potential intentions and reporting outlet choices from the accounting community, based on our understanding. This allows us to explore our original hypotheses further, while raising our awareness such that we hypothesize an extension to theorized and observed behavior. This is done through a series of mixed methods. We gather data from one experiment, briefly conduct an open-ended interview, and conclude with a second experiment as described further below.

EXPERIMENT ONE

Direct Effects

Through its actions, the SEC appears to implicitly assume that as people become aware of the whistleblowing provisions of Dodd–Frank, more fraud will be reported to the SEC. This is borne out by the data showing an increasing number of frauds turned into the OWB’s enforcement hotline. Implicit in this assumption is that the desire to report in a timely fashion will increase as well. Perhaps individuals will fear others might turn the fraud in first, laying claim to whatever portion of penalties which are recovered. Thus, this study first tests the assumption made by the SEC that a regulation which includes whistleblower awards increases intention to report fraud. Formally stated:

H1. An individuals’ intention to delay reporting fraud is less (greater) when the individual is aware (unaware) of the Dodd–Frank Act.

Intention to report increases with materiality (Brink, Cereola, & Menk, 2015; Fatoki, 2013). Brink et al. (2015) examine the impact of fraud materiality on whistleblowing intention by manipulating the dollar amount of false revenues as either 1% or 10% of annual revenues. Fraud materiality appears to be a significant predictor of whistleblowing intention, with a positive relationship between fraud materiality and intention to whistleblow (Brink et al., 2015). Thus, without taking the awareness of Dodd–Frank into consideration, individuals will likely act more quickly when faced with a larger fraud (exceeding the reward threshold) due to materiality. Formally stated:

H2. An individuals’ intention to delay reporting fraud will be less (greater) when the fraud is larger (smaller).

Due to the incentives built into Dodd–Frank, knowledge of the Act may actually introduce a delay in reporting. For example, assume fraud is detected and ongoing at a firm but the fraud is less than \$1 million. Although the Act is designed to increase reporting speed, it is possible that the opposite may occur. Individuals may focus on the \$1 million as a threshold to receive a reward and