

PAC INVITED CONFERENCE
CORPORATE MISCONDUCT, FRAUD &
WHISTLEBLOWING

June 3, 2022

Whistleblowing, Auditing and Enforcement

Discussant: Jonathan Black

Purdue University



Professional Accounting Centre

UNIVERSITY OF TORONTO

MISSISSAUGA



Auditing with a Chance of Whistleblowing

Lin Nan, Chao Tang, and Minlei Ye

Discussion

Jonathan Black

Purdue University

Outline of Discussion

- 1) Review motivations for whistleblowing programs and empirical findings
- 2) Review implications of the model in the paper
- 3) Provide some thoughts based on empirical findings

Employee whistleblowers

Internal Whistleblowing

- Employee concerns raised in a firm's whistleblowing program

External Whistleblowing

- False Claims Act (State and Federal)
- SEC whistleblowing office (IRS, CFTC, PCAOB)
- OSHA – claims of retaliation for internal whistleblowing
- Go public with the information (via the media, etc.)

External whistleblowing allegations are costly to firms (Bowen, Call, Rajgopal 2010)

Whistleblowing programs

Whistleblower protection

- SOX whistleblower protection against retaliation is administered by OSHA
- Unemployment insurance increases whistleblowing (Heese and Pérez-Cavazos 2021)

Whistleblower compensation

- SEC rewards 10%-30% of the money collected as a result of the whistleblowing when sanctions exceed \$1 million
- \$564 million paid to 108 individuals in 2021 (2021 OWB report to congress)

Benefits of whistleblowing programs to regulators

- Motivates those who are informed about fraud to come forward
 - Nearly 40% of all discovered frauds are uncovered by a whistleblower tip (ACFE 2018)
- Whistleblowers facilitate enforcement (Call, Martin, Sharp, Wilde 2018)
 - Higher monetary penalties
 - Enforcement proceedings happen more quickly
- Whistleblowing deters misreporting (Wilde 2017, Berger and Lee 2022)
- Cash for information programs defray costs borne by whistleblowers (Dey, Heese, and Pérez-Cavazos 2021)

Criticisms of whistleblowing programs

- Monetary incentives increase frivolous or misleading complaints making whistleblowing programs costly (Miceli and Near 1996)
- External whistleblowing programs may bypass internal whistleblowing programs (Stubben and Welch 2020)
- Perverse hiring and compensation incentives (e.g., employee stock options – Call, Kedia, and Rajgopal 2016)
- Thresholds for whistleblower compensation create incentive to allow the fraud to grow (Berger, Perreault, and Wainberg 2017)

Overview

Research Question: Will auditors increase or decrease their supply of audit quality in response to a higher likelihood of whistleblowing?

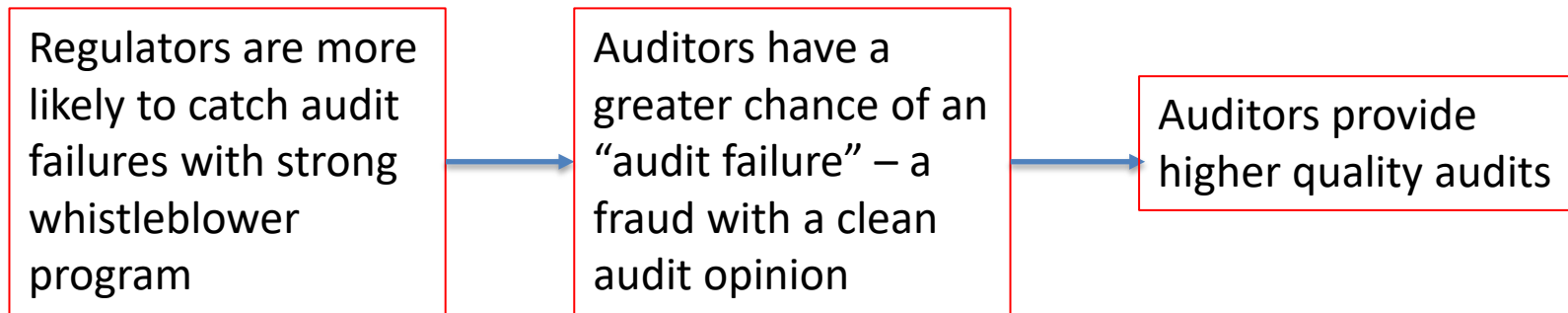
Model provides a framework for thinking about the interaction between whistleblowing, regulators, and auditors.

Implications

Whistleblowing could either increase *or decrease* audit quality depending on regulator reliance on whistleblowers and audit quality's link to regulators

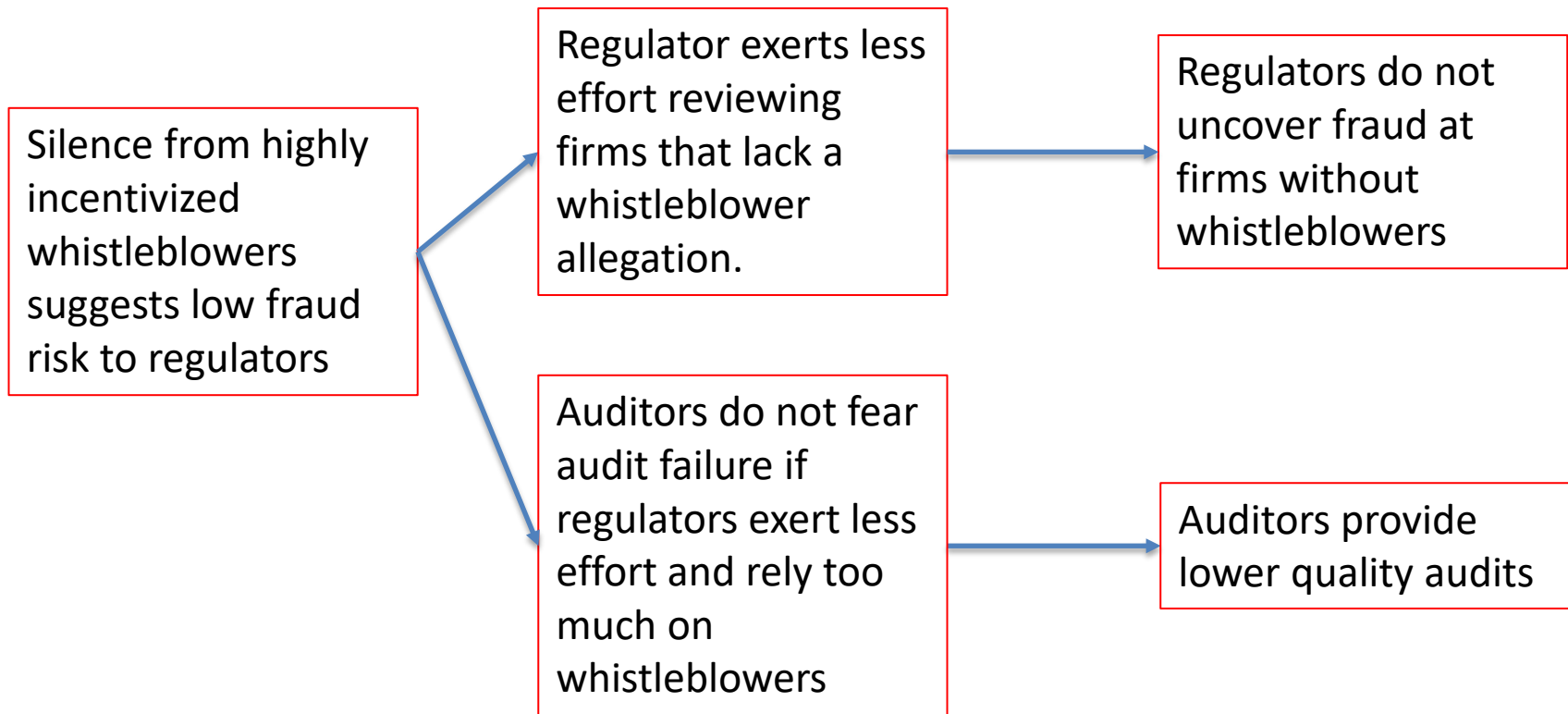
Overview

Increase audit quality:



Overview

Decrease audit quality:



Thoughts

- Very interesting to think about what happens if regulators rely *too much* on whistleblowers
- Resource constraints at regulators have been documented
 - The SEC's enforcement program has limited resources which drives focus to targets they are already informed about (Kedia and Rajgopal 2011)
 - DOJ intervention focuses on cases with high chance of winning (Heese, Krishnan, and Ramasubramanian 2021)

Does regulatory action drive audit quality?

Audit failure (and audit quality) is driven by enforcer/regulator effort either to review filings or to enforce when there is a whistleblower allegation

Fraud detection “takes a village” (Dyck, Morse, and Zingales 2010)

- 10% or more of whistleblowing
 - Employees, Analysts, Short sellers, Media, Industry regulators, Auditors
- Less than 10% of whistleblowing
 - SEC, Clients/competitors, Law firms, Investors

Does the presence of whistleblowers affect other outside monitors?
Are outside monitors (analysts, short sellers, etc.) whistleblowers or enforcers?

Whistleblower allegations

In the model, everyone knows about whistleblower allegations and they reveal fraud every time.

Allegations are often frivolous, private communications

- Whistleblowing could occur before the audit
 - Audit fees increase when whistleblowing occurs (Kuang, Lee, and Qin 2021)
- Who is actually informed about whistleblowing allegations?
- Who *should* be informed about whistleblowing allegations?

Summary

Employee whistleblowing programs that include monetary incentives are popular and expanding.

Model finds that too much reliance on whistleblowers could reduce audit quality and the likelihood of catching audit failures

It would be interesting to allow for imperfect whistleblowing allegations, and to know the effect of other outside monitors.