

# The Effects of Reputation Threat and Whistle-Blowing Report Source on Chief Audit Executives' Investigation Decisions

## EXECUTIVE SUMMARY

By Cynthia P. Guthrie  
Virginia Commonwealth University

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Whistle-blowing has gained new notoriety since the corporate scandals earlier this decade. Although whistle-blowing was previously recognized as a key factor in fraud deterrence by such bodies as the US Congress, the US Merit Systems Protection Board and the Committee of Sponsoring Organizations of the Treadway Commission (COSO 1992), more recent legislation gives whistle-blowers increased access to reporting channels as well as increased legal protection.

The Sarbanes-Oxley Act of 2002 (hereafter, SOX) was passed by Congress to improve the quality of financial reporting by public companies. Section 301 (4) of SOX specifically charges the audit committees of public companies with establishing procedures for receiving and handling complaints regarding accounting, internal accounting controls, or auditing matters, and more specifically, with establishing a confidential and anonymous channel for such complaints.

Most studies on whistle-blowing were conducted before the reporting channels mandated by SOX were available and known to employees. However, recent evidence suggests that these anonymous reporting channels may not have the effect that the sponsors of SOX intended. The introduction of an anonymous whistle-blowing channel may decrease reporting intentions across all channels (Kaplan and Schultz 2007).

A benchmarking report that compiled data from 2003 through 2006 to show how participants use reporting hotlines indicated that 54 percent of all reports received were anonymous. The hotlines were most often used to report personnel management incidents (51 percent of calls) and only 10 percent of reports were related to corruption and fraud. Moreover, those reporting fraud and corruption chose to remain anonymous only 36 percent of the time (Security Executive Council 2007). Although evidence is mixed as to the effectiveness of and the need for an anonymous channel to report fraud, employee reporting remains an important source of fraud detection (PricewaterhouseCoopers 2007).

If employee reporting is an important source of information for fraud detection and prevention, then the investigation of all whistle-blowing reports should be taken seriously by the audit committee and executive management. However, extant research shows that people view communications received from anonymous individuals as less trustworthy and as less credible (Rains 2007; Hunton and Rose 2008). Furthermore, source credibility has been shown to be an important factor in auditors' judgment and decision making processes; information from less credible sources may be discounted (Bamber 1983; Hirst 1994; DeZoort et al. 2003). Consequently, follow up on whistle-blowing reports from anonymous sources may not be given the appropriate attention by report recipients.

Taken as a whole, current evidence is inconclusive as to whether the SOX mandated anonymous whistle-blowing channels are useful and under what circumstances they may be more or less conducive in decreasing fraudulent financial reporting. This study employs experimental research methodology to add insight to the question posed by Hooks et al. (1994, 105), "Should

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anonymous reports be encouraged?" by examining the impressions of and responses to anonymous versus non-anonymous whistle-blowing reports alleging fraudulent financial reporting.

SOX charges executive management with creating, documenting, and maintaining a strong system of internal controls, especially over financial reporting. Furthermore, SOX has significantly increased the culpability of executive management if they fail to carry out these duties and of external auditors if they fail to detect insufficient controls. As a result, the role of internal audit with regard to internal control systems has expanded considerably. Executive management and external auditors have come to rely on internal audit not only to assist in establishing and documenting these control systems, but also to test and preserve compliance with them. Accordingly, the role of many internal audit functions has shifted to that of ensuring financial control compliance (Nagy and Cenker 2007).

An additional outcome of SOX is the audit committee's increasing reliance on internal audit and especially the Chief Audit Executive (CAE). Current professional guidance suggests that the CAE should report functionally to the audit committee and administratively to executive management (IIA 2000). Audit committee members, now all independent from executive management, often look to the CAE to reduce the information asymmetry between them and management (Raghunandan et al. 2001). In addition to the CAE's roles of ensuring compliance with internal controls and serving as an information source, audit committees often call on the CAE to be the recipient of whistle-blowing reports. A recent study indicated that in the majority of companies responding the internal audit department had sole responsibility for documenting, investigating, and resolving whistle-blowing reports. Furthermore, CAEs had the responsibility of following up on allegations from anonymous whistle-blowers in 71 percent of the sampled companies (Kaplan and Schultz 2006).

Prior research has not considered a complete view of the whistle-blowing process. Rather the extant research has focused on whistle-blowers, what they choose to report, their motivations for reporting, how they choose a reporting channel, and the possible retaliation they encounter after their actions. A whistle-blowing report is not helpful in uncovering wrongdoing if it is not properly received, investigated, and resolved. A key element in the upstream of the whistle-blowing process is the person receiving the report (Hooks et al. 1994). Consequently, to understand the entire picture of the post-SOX environment, the subsequent actions of whistle-blowing complaint recipients should also be scrutinized. The current inquiry expands our understanding of whistle-blowing effectiveness by exploring both CAEs' judgments about and decisions to investigate reports of alleged wrongdoing.

In working with and supporting executive management, external auditors, and the audit committee, it is clear that the role of the CAE has become politically complex. The Code of Ethics of the Institute of Internal Auditors (IIA) charges its members with upholding the principles of integrity, objectivity, and competency (IIA 2000). In relation to SOX internal control issues, the IIA's position paper warns CAEs not to become involved with assisting executive management to an extent that would obstruct their objectivity and independence. Yet, the authors of the position paper admit that such a balance is difficult to maintain (IIA 2004).

This balancing act can create and exacerbate moral dilemmas for the CAE when making judgments and decisions. When forming judgments and making subsequent decisions about a specific event or state of affairs, individuals go through the process of accessing pertinent existing beliefs. This process includes not only the intentional accessing and evaluation of such beliefs, but also the inclusion of unacknowledged beliefs and motives. Thus, the judgment and decision making process may include pre-decision biases that give way to motivated reasoning. Motivations may be primarily driven by the desire to be accurate, or by the desire or need to reach a specific conclusion. Self-esteem, self-preservation, the need to maintain control, and the need to maintain consistency are examples of directional goals (Pyszczynski and Greenberg 1987; Kunda 1990).

Research shows that motivated reasoning can be a significant factor in accounting related judgment and decision making scenarios. For example, auditors' decisions have been influenced by potential client loss and other client related risks (e.g. Farmer et al. 1987; Hackenback and Nelson 1996; Beeler and Hunton 2002; Kadous et al. 2003; Blay 2005). However, there is a paucity of research that explores similar phenomena with respect to internal auditors. This study focuses on the judgment and decision making of an understudied but important population in accounting research, the CAE.

The purpose of this study is, thus, to investigate the effects of reputation threats that may give rise to motivated reasoning and the provision of anonymous whistle-blowing channels on CAEs' decisions to investigate whistle-blowing allegations. To accomplish this, a two by two, between-participants experiment was administered to 47 CAEs and 47 Deputy CAEs. Participants had mean internal audit experience of 13.1 years and mean tenure in their current organizations of 9.4 years. Forty-nine and four tenths percent were CIAs and 60.5% were CPAs. Eighty-three percent of participants worked for publicly traded companies.

After reading a case study that described a whistle-blowing allegation, participants were asked to assess the credibility of the whistle-blowing report and allocate resources toward investigating the alleged wrongdoing. Study results show that CAEs ascribed a lower level of credibility to anonymous whistle-blowing reports than to non-anonymous reports. However, resource allocations were not significantly different for the two experimental conditions. Instead, the debriefing question responses and CAE comments suggest that participants intentionally ignored their perceptions of credibility of the whistle-blowing report and purposed to fully investigate the alleged wrongdoing.

CAEs also judged whistle-blowing reports that suggested wrongdoing was perpetrated by the exploitation of substantial weaknesses in previously evaluated internal controls (higher reputation threat) to be less credible than those which reported that the alleged wrongdoing was accomplished by the circumvention of internal controls (lower reputation threat). Nevertheless, participants in the Exploitation condition did not indicate significantly different levels of perceived reputation threat than did CAEs who were in the Circumvention condition. Moreover, the method of wrongdoing did not have a significant influence on CAEs' allocation of investigatory resources. Those in the Exploitation condition did indicate a significantly higher

level of perceived responsibility for the wrongdoing than did those in the Circumvention condition.

This experimental case study was adapted from Hunton and Rose (2008) which examined audit committee members' judgments regarding the credibility of anonymous versus non-anonymous whistle-blowing reports and investigatory resource allocations in the presence of two levels of reputation threat. The participants in the Hunton and Rose (2008) study were all audit committee members (ACMs) with mean business experience of 23 years. Seventy-five percent of the participants were considered to be the financial expert on their respective audit committees. Similar to CAEs in the current study, ACMs assessed non-anonymous whistle-blowing reports to be more credible than those from anonymous sources. Both CAEs and ACMs in the high reputation threat conditions made lower credibility assessments.

On the other hand, the resource allocation decisions among CAEs and ACMs were markedly different. Hunton and Rose (2008) found that resource allocation decisions of ACMs were significantly influenced by both report source and reputation threat. They concluded that ACMs might fail to sufficiently investigate allegations of wrongdoing received through anonymous whistle-blowing channels and that a high reputation threat condition may exacerbate this shortcoming. The current study indicates that CAEs are not significantly influenced by either the nature of the report source or by a reputation threat when making investigatory resource allocation decisions. Debriefing questions in both studies addressed participants' impressions of anonymous reports. In summary, CAEs judged anonymous reports to be more credible, more difficult to investigate, and more useful than did ACMs.

Both internal audit functions and audit committees are important bodies within the corporate governance structure. The results of the current study, when contrasted with Hunton and Rose (2008), suggest that CAEs and ACMs may approach whistle-blowing reports, especially those from anonymous reporters, differently. In this particular scenario CAEs who were internal to the organization and considered as a part of management appeared to be quite intentional in their duties as sentinels. On the other hand, the prior study indicated that ACMs who are charged with being overseers of the whistle-blowing process may not be as diligent. This insight could prove especially valuable for CAEs who depend on audit committee funding for the investigation of such whistle-blowing allegations. Several participant comments from CAEs indicated that they would obtain as much funding as needed from the audit committee to investigate the allegations of wrongdoing. The results of the Hunton and Rose (2008) study suggest that the check book may not be completely open, especially for whistle-blowing reports received from anonymous sources.