Whistleblowing And External Auditors

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Abstract

New federal legislation now makes it mandatory for auditors to disclose observed misconduct to outside agencies. This article examines this legislation and presents data from a national sample of 353 auditors to explore the level of support for these new regulations. The vast majority of auditors are found to oppose the legislation, but there are also major differences in opinion for different groups of auditors. The implications of these survey results are then discussed.

Introduction

Social scientists and policy analysts have increasingly recognized the importance of whistleblowing as a method of exposing and controlling mismanagement, waste, financial fraud, and other types of criminal activity in the modern workplace (see Miethe and Rothschild 1994). Realizing the societal benefits of whistleblowing and the hesitancy of workers to press action against their employers, both federal and state legislation has been enacted to promote the reporting of misconduct as ethical behavior and to protect whistleblowers. Legal efforts involve amendments to Civil Service Reform Act for added protection of federal workers against unlawful discharge, the use of qui tam lawsuits under the False Claims Act to financially compensate whistleblowers for their actions, and mandatory reporting statutes for teachers and social workers who observe suspected cases of child abuse.

Among various professionals, accountants and auditors are in an especially strategic

position to observe financial fraud. Whether these professionals are under a moral or legal obligation to report this misconduct and to whom it should be reported, however, are key issues facing the auditing profession today (Brodsky 1993; Wall Street Journal 1998). Effective for audits of financial statements for periods ending December 15, 1997, the American Institute of Certified Public Accountants has for the third time issued new guidance for the consideration of fraud in a financial statement audit (AICPA 1997). After observing misconduct, however, these professionals must ultimately weigh the relative costs and benefits of reporting or remaining silent.

The major costs for the whistleblower involve potential retaliation by the employer, whereas the auditing firm runs the risks of losing its clients by encouraging external reporting of financial fraud and being sued by the client for violating their confidential relationship (Keenan and Krueger 1992). Future clients may also be lost once an auditing firm gets the reputation of being a whistleblowing firm. The major benefits from whistleblowing include reductions in possi-

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ble legal liability for failure to disclose misconduct and saving the auditing firm from adverse publicity for remaining silent (Miceli and Near 1992; GAP 1997).

The moral and legal status of whistleblowing in the auditing profession is undergoing a major transformation (Rechtschaffen and Yardley 1995). Specifically, new federal legislation is an attempt to encourage whistleblowing as pro-social behavior by making it mandatory for auditors to disclose misconduct to outside agencies. This legislation, however, may be in direct opposition to both the rules of the accounting profession and the opinions of its members.

Using a national survey of 353 auditors, this article examines whistleblowing legislation and its level of acceptance by various types of auditors. The paper concludes with a discussion of the sources of resistance to this legislative action and its consequences for the promotion of whistleblowing as moral behavior within the workplace.

Whistleblowing and the Auditor

State and federal legislation over the last decade has provided greater protection to whistleblowers in a variety of work settings. On October 31, 1994, President Clinton signed into law legislation that grants additional protections for federal employees who report fraud, waste, and mismanagement. This law, PL 103-424, also reauthorizes the Merit System Protection Board and the Office of Special Counsel for a period of three years.

To help refocus the audit profession on fraud, then U.S. Representative Ron Wyden (D-Ore.) (Now Mr. Wyden is a Senator from Oregon) had introduced an amendment to the Securities Exchange Act of 1934 that focuses on auditor's responsibility for the detection and the disclosure of financial fraud. The eventual new law imposed specific audit requirements on the

accounting profession. Specifically, any public corporation being audited must now include (1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts, (2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and (3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

If the independent auditor detects or becomes aware of financial fraud, the law specifies that the auditor should determine the possible effect of the illegal action and inform the appropriate level of management. Upon disclosure to management of serious illegal activity, the independent public accountant is further obligated to report its conclusions to the Board of Directors if remedial action is not taken in a timely fashion. The Board of Directors is then responsible for notifying the SEC that they have received a report about illegal acts. The Board is also obligated to give a copy of the notice they sent to the SEC to the independent public accountant. If the Board fails to comply with these mandates in any way, the independent public accountant must resign from the engagement and furnish the SEC with a copy of the report.

For the auditor, the major component of the law is the stipulation that "if there is a major fraud perpetrated at a corporation and corporate management refuses to correct the abuse, the corporation's accountant would be required to report the fraud to government regulators (Congressional Record, March 8, 1995, H2846). Endorsed by the American Institute of CPAs, the amendment provides a more efficient way for auditors to report misconduct to internal or external agents and is thought to deter frivolous lawsuits against accountants by precluding private rights of action against them for whistleblowing.

A decade after the darkest days of the Savings and Loan collapse, the financial fraud and disclosure amendment will answer the question: Where were the accountants and why didn't they speak up? During this period of time, many economists and policymakers decried the financial greed and excesses that were occurring, but found that the Federal government was not properly armed to fight against these losses. With the bankruptcy of several S&L's in California in 1985 and 1986 (after having received unqualified audit opinions), Congress decided that they must take action. A General Accounting Office report found that accountants had issued unqualified opinions as to a net worth of \$44 million on 11 failed thrifts that were actually bankrupt. Twenty-eight of the thirty S&L's in California went bankrupt after receiving unqualified audit opinions. How do we get auditors to immediately disclose financial frauds and prevent a repeat of such actions?

Even though current professional standards require auditors to look for fraud, there are several pressures that deter auditors from being as complete as they could be in observing and disclosing misconduct. The current accounting literature only requires the auditor to report fraudulent activity that is not material to an appropriate level of management at least one level above those involved. For fraud resulting in a material effect on the financial statements, the auditor also should suggest that the client consult with legal counsel. Furthermore, if the fraud involves senior management and/or is material the auditor should also report directly to the audit committee. The accounting literature further states that if these frauds mentioned above relate to a public company, the auditor is required by the Private Securities Litigation Reform Act to report directly to the Securities and Exchange Commission (SEC). This amendment further gives the auditor "a safe harbor" protection by indicating they are not liable in a private action for any report made under this amendment.

Accountants and auditors have always been in a unique position to observe various types of misconduct within organizations. With the recent activity in Congress and in the Executive Branch, auditors are being made more responsible for reporting to outside agents what they observe. Even though the accounting literature is now more clear and closer to the federal laws, it is not clear if external reporting by the auditor is taking place. We also know very little about how often misconduct is observed by auditors and their attitudes about these new laws and proposed legislation. To address these issues, the authors designed and distributed a mail questionnaire for the purpose of determining what were the opinions of auditors toward the new federal legislation and their experiences in observing and reporting fraud.

Research Methods and Univariate Statistics

This survey was sent to 4,000 auditors throughout the United States. The surveys were distributed to a random sample of members of the AICPA in order to get opinions from those in large, medium and small firms, as well as CPA's in industry and government. A total of 353 surveys were returned. Nearly two-thirds (61%) of the respondents were auditors in small firms (less than 10 employees), one-fourth were from mid-size firms (11 to 99 employees), and the remaining 14% were in large firms (over 100 employees). The majority of auditors in the survey were employed in the profession for over 5 years (66%), male (72%), married (78%), observed financial fraud and falsification of records by their client (51%), and reported client misconduct to someone else in the auditing firm or an official outside the firm (65%). Internal disclosure (75%) was far more likely than external whistleblowing (25%).

Attitudes Toward Federal Legislation and Whistleblowing

The key questions in the survey elicited the opinions of auditors toward changes in fed-

eral legislation that encourages whistleblowing and to whom auditors should report organizational misconduct. The pattern of these results and how they differ by the characteristics of auditors are presented in Table 1 and summarized below.

dramatic differences in opposition toward the new federal legislation involved comparisons between partners and staff auditors. 93% of partners in auditing firms said they were opposed to this legislation compared to only 58% among staff auditors.

Table 1: Attitudes Toward Whistleblowing For Different Groups Of Auditors								
<u>Attitude</u>	<u>All Employees</u>	<u>Firm Partner</u>	<u>Staff Auditor</u>	<u>Seasoned Auditor</u>	<u>Novice Auditor</u>	<u>Firm Size</u>		
						<u>Small</u>	<u>Medium</u>	<u>Large</u>
Oppose Federal Legislation Requiring External Reporting of Misconduct	73%	93%	58%	76%	65%	72%	75%	64%
Favor Reporting Fraud and Misconduct to the Following Groups:								
a. The Client?	99%	100%	100%	99%	97%	98%	100%	95%
b. Partners and Firm's Senior Staff?	96%	95%	98%	95%	98%	97%	96%	95%
c. Security Exchange Commission?	49%	37%	64%	50%	47%	48%	53%	53%
d. Government Accounting Office?	22%	20%	36%	23%	20%	24%	27%	14%
e. Congressional Officials?	4%	2%	8%	4%	4%	5%	4%	5%
External Whistleblowing is Violation of AICPA Code of Ethics (% "Agreed")	62%	76%	47%	65%	58%	66%	64%	41%
By "Blowing the Whistle", firm will lose that client in the future (% "Agreed")	91%	94%	92%	92%	88%	93%	90%	87%

When asked their opinions about proposed federal legislation that places more responsibility on auditors for reporting misconduct to outside officials, the vast majority of respondents (73%) said they were opposed to this action. Novice auditors (those in the profession less than 5 years) and auditors in large firms were more supportive of the legislation than their counterparts, but even for these groups opposition was more common than support. The most

Currently, generally accepted auditing standards requires that auditors report fraud and other illegal acts to a level of management higher than where the act occurred. When the auditors in this survey were asked where they should report these acts, the vast majority felt they should report them to the client (99%) or to partners and senior staff in their firm (96%). Less than half (49%) said they should report misconduct to the SEC, and less than one-fourth (22%) felt the

GAO was an appropriate agency for reporting. Only 4% of the auditors in our survey thought that Congress should be informed of illegal activity.

Comparisons across types of auditors revealed several differences in their perceptions of who should be informed of organizational misconduct. Staff auditors were far more likely than partners to view the SEC, GAO, and Congress as appropriate outlets for reporting illegal activity. There were few differences in attitudes based on the size of auditing firm, but employees of large firms were found to be less receptive than employees of other size firms to reporting misconduct to the GAO. Different types of auditors were similar in their general acceptance of clients and higher management officials as appropriate sources for disclosure. Regardless of the type of firm, organizational position, or length of service, over 90% of the auditors thought clients and upper management should be informed of illegal activity.

Finally, several additional questions were asked in the survey to gain a better understanding of the attitudes of auditors toward whistleblowing. For example, nearly two-thirds of the sample (63%) thought that external whistleblowing (i.e., reporting misconduct to outside sources) would be a violation of the AICPA Code of Ethics that requires confidentiality between the auditor and client. Novice auditors and those employed in large firms were far less likely than other auditors to view whistleblowing as a violation of this code. When asked whether they thought "blowing the whistle" would result in losing that client for the future, the vast majority of auditors (91%) responded affirmatively.

Summary and Conclusions

Realizing the benefits of whistleblowing for exposing and controlling organizational misconduct, state and federal legislation has been passed to encourage whistleblowing and protect those that do so from retaliation. Within the

field of auditing, recent federal laws and accounting regulations are designed to increase the responsibility of auditors for reporting financial fraud and other illegal activity.

The results of the current study clearly reveal that most auditors in our sample are strongly opposed to efforts to increase whistleblowing. Nearly three-fourths of auditors are opposed to this legislation and this opposition is strong across different types of auditors with different experiences and organizational positions. Auditors are nearly universally opposed to the disclosure of misconduct to Congress. However, while opposition to changing current auditing practices is strong, an emerging pattern in the survey data involves pockets of support for whistleblowing among specific types of auditors. Specifically, there appears to be a notable minority of novice auditors, staff auditors, and those employed in large firms who are generally more receptive toward whistleblowing and consider it more of a professional responsibility. Except for this minority of auditors, the prevailing attitudes of auditors in our sample is counter to both the enacted federal legislation and the auditing profession's own rules and regulations.

From the perspective of public policy, the apparent disjunction between the attitudes of auditors and current legislation is important because it suggests that the intended actions may not result in changes in actual auditing practices. Specifically, social scientists have long recognized that practitioners will go to extraordinary lengths to circumvent both the spirit and letter of reform efforts that they do not themselves support (see Miethe 1987; Miethe and Moore 1988). In the current context, the widespread opposition to increasing auditors' responsibility for reporting fraud and illegal activity means that auditors need to be further educated on the private and collective benefits of whistleblowing. This is especially true when one recognizes that the loss of clients may be a strong financial incentive for auditors and their firms to remain silent about observed misconduct (*Accountancy Age* 1990).

Given that auditors in upper management positions are most opposed to whistleblowing, educational efforts should be directed first and foremost to these core members of the auditing profession. Without the support of upper management, it is likely that ongoing federal legislation will be primarily symbolic and have little impact on the daily activities of auditors.

Suggestions For Future Research

The results of our survey of auditors suggest several areas of interest for future research. First, it would be interesting to determine whether similar attitudes for auditors from small, medium and large sized firms hold true at various times after the passage of the new laws. Our current study does not allow us to determine whether resistance by auditors will increase or dissipate through time. Performing a similar survey in the future would answer this question. Second, an important area for study is the client's perceptions of these new disclosure laws. Such research would determine whether and to what extent whistleblowing legislation affects a firm's ability to acquire and retain clients. Third, future research should follow closely the subsequent modifications and extensions of this federal legislation. This research would indicate whether greater regulation or a period of increasing deregulation best characterizes future trends in the auditing profession. Finally, and maybe most importantly, it is necessary to determine if auditors from different sized CPA firms have been "blowing the whistle" more since the passage of this new legislation.

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