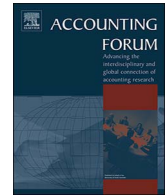


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Whistleblower laws and corporate fraud: Evidence from the United States[☆]

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ABSTRACT

We use data from the United States to assess whether whistleblower laws that protect private employees from retaliation have an impact on corporate fraud. Currently, eighteen states have whistleblower laws that offer such protection. Our analysis indicates that, in these states, a higher awareness of whistleblower laws is associated with a lower state-level conviction rate for corporate fraud. This finding is consistent with the hypothesis that whistleblower laws that cover private employees have a deterrent effect on corporate fraud, and that awareness of the provisions of whistleblower laws plays a key role in determining their effectiveness as a policy tool.

1. Introduction

Whistleblowing is widely believed to play an important role in uncovering government and corporate malfeasance.¹ Consequently, many international organizations have become strong advocates for laws that protect whistleblowers from retaliation. Some prominent examples include Transparency International, which has published a set of “recommended draft principles for whistleblowing legislation,” and the Council of Europe, which has called upon member states to establish “a normative, institutional and judicial framework to protect individuals who, in the context of their work-based relationship, report or disclose information on threats or harm to the public interest.”² In the same vein, a major Australian research project on whistleblowing has recently called for strengthening protections, noting that the preliminary findings of the project “point to a need for further reform and stronger oversight in the public sector, and especially confirm that for the private and not-for-profit sectors, a well-informed legislative overhaul is overdue.”³

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¹ The term “whistleblower” made its way into the popular lexicon largely due to the actions of U.S. consumer activist Ralph Nader. In January 1971, he and a number of associates gathered in Washington D.C. for a “whistleblower’s conference” that showcased government employees who had publicly exposed government activities that conflicted with the public interest. Although the conference focused on government employees, whistleblowing has taken on a broader meaning in the intervening years. One widely-cited definition, which is due to [Near and Miceli \(1985\)](#), holds that whistleblowing is “the disclosure by organization members (former or current) of illegal, immoral or illegitimate practices under the control of their employers, to persons or organizations that may be able to effect action.”

² See [Transparency International \(2009\)](#) and [Council of Europe \(2014\)](#) for details.

³ See [Brown et al. \(2016\)](#) for details.

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In this paper, we investigate whether whistleblower laws that protect private employees from retaliation are an effective policy tool for deterring corporate fraud. Such laws have garnered considerable attention in the United States in the wake of the numerous accounting scandals of recent years.⁴ The actions of companies such as Enron, WorldCom, and HealthSouth have caused investors to lose billions of dollars, and have shaken investor confidence in financial statements and auditors (Hobson, Mayew, & Venkatachalam, 2012). Despite the important role of independent auditors in supporting well-functioning capital markets, very few jurisdictions impose a duty on auditors to report irregularities to regulatory authorities.⁵ Whistleblower laws hold the potential to complement the deterrent effect of external audits by encouraging employees to expose fraud and other forms of corporate malfeasance.

Not surprisingly, academic studies of whistleblowing indicate that it is far from a riskless endeavour. Dyck et al. (2010), for example, examine 216 cases of alleged corporate fraud, and report that employees who helped to expose the alleged fraud declined to identify themselves in 45% of the cases to avoid suffering adverse consequences. For the cases in which the employees were named, the majority reported that they were fired or demoted as a result of exposing the alleged fraud. These findings suggest that protection from workplace retaliation should help to incentivize employees to come forward with information about fraudulent business activities.⁶

We develop empirical evidence on the relation between whistleblower protections and corporate fraud using data from the United States. These data are well suited to such an undertaking due to the multi-jurisdictional aspects of the U.S. legal system. Although there are federal statutes that protect whistleblowers in the public sector, the individual states are free to enact their own whistleblower laws provided that these laws do not conflict with federal law. Most states appear to view whistleblower anti-retaliation measures as a key mechanism for deterring wrongdoing (Callahan and Dworkin, 2000), and all fifty states have some form of whistleblower law in place. But the specifics of these laws, such as type of whistleblower protected, the appropriate disclosure recipient, and remedies for retaliation, display wide variation across states.

By exploiting the state-level variation in statutory whistleblower protection, we can assess the impact of whistleblower laws on the prevalence of corporate fraud. Our basic hypothesis is that these laws should help to deter fraud by increasing the likelihood that it will be detected and punished. But we expect the effectiveness of the laws to be a function of several factors. First, laws that offer protection to *private* employees should be more effective at deterring corporate fraud than those that focus only on public employees. Second, managers and other employees must be aware of the law and its provisions in order for it to be effective. Third, the effectiveness of a law should depend on its overall strength, as determined by the combination of all its features.

We use three variables to capture these factors. The first is an indicator variable that identifies the 18 states that protect *private* employees from retaliation.⁷ The remaining two variables are designed to measure the strength of whistleblower laws, and the level of awareness with respect to the laws. We use internet searches to construct the awareness variable, as in Goel and Nelson (2014). To measure the strength of whistleblower laws, we use an index that is published by the Public Employees for Environmental Responsibility (PEER) organization.

Our measure of corporate fraud is constructed using information compiled from the Executive Office for U.S. Attorneys (EOUSA) by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University. The TRAC database lists the number of corporate fraud prosecutions filed and the number of corporate fraud convictions by state judicial district beginning with 2003. We aggregate the judicial district data to obtain a measure of corporate fraud at the state level, and divide by the number of non-farm employees in the state to obtain a conviction rate. We conduct the analysis using conviction data for the years 2003–2015.

The research design is straightforward. We estimate cross-section regressions of the state-level conviction rates for corporate fraud on the three variables discussed above, and include an interaction variable to allow for the possibility that the effect of the anti-retaliation provisions of whistleblower laws differs across states with high and low awareness. The regression evidence is consistent with our hypothesis regarding the deterrent effect. Specifically, we find that a higher awareness of whistleblower laws is associated with a lower conviction rate for corporate fraud for states whose whistleblower laws have provisions that protect private employees. This evidence is robust to the use of a variety of control variables. We also consider the impact of state *qui tam* laws, but find little evidence of a deterrent effect with respect to corporate fraud.⁸ This finding is not surprising in view of the limited scope of such laws.

Our results on the deterrent effect of whistleblower laws complement the recent findings of Wilde (2017), who investigates the effect of whistleblowing by employees of U.S. corporations on the behaviour of these corporations in subsequent time periods. His analysis suggests that allegations raised by whistleblowers have a deterrent effect on both financial misreporting and tax aggressiveness, and that this effect can be observed for at least two years after the year in which the allegation was made. Our analysis is fully consistent with this finding, and suggests that strengthening state-level whistleblower laws is an effective way for U.S.

⁴ The interest in such laws appears to be growing in other countries as well. Whistleblower laws in Australia, for example, have historically focused on public employees. However, in the Draft Open Government National Action Plan for 2016–2018, the Prime Minister and Cabinet commit to improving “whistle-blower protections for people who disclose information about tax misconduct to the Australian Taxation Office,” and state that they will “consult on other reform options to strengthen and harmonise whistle-blower protections in the corporate sector with those in the public sector.” See <https://www.pmc.gov.au/resource-centre/public-data/australias-first-open-government-national-action-plan-2016-18-fact-sheet>.

⁵ South Africa is perhaps the best example of a jurisdiction in which external auditors are duty-bound to blow the whistle on wrongdoing by their clients. Maroun and Solomon (2014) argue that this reporting duty enhances the perceived legitimacy of the audit profession.

⁶ Prior research suggests that the likelihood of whistleblowing depends on a number of factors, including organizational policies and procedures (Seifert, Sweeney, Joireman, & Thornton, 2010), the presence of monetary and reputational incentives (Dyck, Morse, & Zingales, 2010), the monitoring role of the press (Miller 2006), and the regulatory environment (Maroun and Solomon 2014). For a detailed review of fraud-related literature, see Trompeter et al. (2013) and Trompeter et al. (2014).

⁷ State whistleblower laws typically do not provide for pecuniary compensation.

⁸ These laws, which are specific to the United States, allow whistleblowers (private citizens) to file lawsuits against companies that are defrauding the state government. If the state recovers funds as a result of the lawsuit, the whistleblower is entitled to receive a share of the funds.

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