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Lori Wright
UNH Media Relations

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Anonymous Whistle-Blowing Systems Are Often Dysfunctional, New Research Finds

Media Contact: Lori Wright
603-862-0574
UNH Media Relations

Contact for Information: Jacob (Jake) Rose
603-862-0164
UNH Whittemore School of Business and Economics

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Editors and Reporters: A copy of the study is available at
http://www3.interscience.wiley.com/cgi-bin/fulltext/123301737/PDFSTART.

DURHAM, N.H. – Landmark regulations designed to detect and deter financial fraud via anonymous whistle-blowers can be dysfunctional and ineffective, according to new research from the University of Hampshire.

In the first study to investigate the effects of anonymous reporting channels and reputation threats on investigations of whistle-blowing allegations, Jacob Rose, associate professor of accounting at UNH, and co-author James Hunton, the Darald and Juliet Libby Professor of Accounting of Bentley College, find there are disturbing unintended consequences of the Sarbanes Oxley Act of 2002, which requires audit committees of publicly traded firms provide an anonymous whistle-blowing channel to employees in order to detect and deter financial fraud and to protect whistle-blowers from persecution.

The research is published online and will appear in print in the Journal of Management Studies in the article, "Effects of Anonymous Whistle-Blowing & Perceived Reputation Threats On Investigations of Whistle-Blowing Allegations by Audit Committee Members."

The study is based on an experiment in which 83 highly experienced audit committee members evaluated the credibility of a whistle-blowing allegation related to financial reporting malfeasance by corporate executive officers and allocated resources toward the investigation of the whistle-blowing allegation.

The researchers find that audit committee members can fail to sufficiently investigate whistle-blowing allegations received through anonymous whistle-blowing channels relative to non-anonymous channels, especially when the allegations pose reputation threats to the corporate directors.

"We concluded that audit committee members who evaluate whistle-blowing allegations and determine whether or not allegations should be investigated treat anonymous and non-anonymous allegations very differently. Audit committee members find anonymous
allegations to be less credible than non-anonymous allegations. As a result, audit committee members often choose not to investigate an anonymous allegation, even when the allegation indicates very serious threats to the integrity of the financial reporting system. When an identical allegation is not anonymous, audit committees allocate significant resources to the investigation of the allegation. In brief, anonymous allegations appear to be ignored in many cases,” Rose said.

“What is particularly disturbing, however, is that we also find evidence that reputation threats faced by corporate directors have significant influences on decisions to investigate allegations. We find that when an allegation poses threats to a director’s professional reputation, a form of predecisional distortion of information occurs. Essentially, when audit committee members recognize that an allegation threatens their reputations, they have incentives to not investigate the allegation. These incentives cause the audit committee members to perceive that the allegation is less credible, which provides justification for deciding not to investigate the allegation,” Rose said.

“The data indicate that reputation threats can create conflicts of interest, and directors appear to favor personal reputations over obligations to oversee financial reporting quality. Results suggest that anonymous reporting channels provide directors with a way to rationalize decisions to ignore allegations by ascribing low credibility to anonymous allegations that pose reputation threats. Regulators and shareholders currently rely on anonymous whistle-blowing systems to prevent and detect financial statement fraud. Our findings call into question whether anonymous whistle-blowing actually improves corporate governance,” he said.

The researchers believe substantial changes must be made regarding who evaluates whistle-blowing allegations.

“The effectiveness of whistle-blowing mechanisms is critical for the prevention of financial statement fraud. We believe that it is now essential to determine who should be charged with evaluating anonymous allegations. If we want whistle-blowing mechanisms to be effective, then shareholders, regulators, and academics need to identify an independent third party who can determine the veracity of allegations without being influenced by reputation threats,” Rose said.

Jacob Rose is an associate professor at the University of New Hampshire Whittemore School of Business and Economics. He conducts experimental research related to judgment and decision-making in the contexts of corporate governance, auditing, and accounting. He has published psychology-based studies in a wide variety of academic journals and holds a Ph.D. from Texas A&M University.

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