

## CFO insights: Whistleblowing after Dodd-Frank: New risks, new responses

The Dodd-Frank Act has created a large financial incentive for whistleblowing in companies across all industries. As regulatory enforcement against fraud is increasing both domestically and internationally, the whistleblower provisions of Dodd-Frank have the potential to expand prosecutions of fraud dramatically.

### **Dodd-Frank: Whistleblower Considerations**

The Dodd-Frank legislation has broad application across industries based on the authority granted to the Securities and Exchange Commission (SEC) and applies to all SEC registrants as well as entities regulated by the Commodities Futures Trading Commission (CFTC). The Dodd-Frank Act permits whistleblower awards of 10-30 percent of the amount of monetary sanctions in cases where they exceed \$1 million. To receive an award, the information provided must be "original," essentially meaning that it must be derived from the whistleblower's independent knowledge or analysis only and not known to the Commission from any other source. The information can apply to any type of securities law violation including insider trading, fraudulent financial reporting, and Foreign Corrupt Practices Act (FCPA) violations. Of these, the FCPA is particularly relevant, generating fines as large as hundreds of millions of dollars for an individual case.

In combination with its reward provisions, the Dodd-Frank Act also enhances whistleblowers' protection from retaliation by their employers. This is accomplished through both the expansion of the whistleblower protections of the Sarbanes-Oxley Act of 2002 (SOX) and the creation of new sources of protection with streamlined procedural requirements, extended statutes of limitations, and more severe penalties for retaliatory employers. Awards aren't limited to employees; they can extend to anyone – including vendors, customers, investors, financial analysts, short-sellers, fund managers and others.

The Dodd-Frank Act could result in an individual collecting a multiple of his or her normal lifetime earnings as a result of reporting fraud. Some law firms are now advertising to represent and motivate whistleblowers just as attorneys represent False Claims Act plaintiffs (for a share of any proceeds). As more individuals become aware of the potential rewards of whistleblowing, companies receiving allegations of securities fraud and being investigated by the SEC may increase substantially. Whether or not those investigations reveal actual violations, the costs and disruption of responding to such allegations can be substantial.

Although not finalized at the time of writing, the SEC has proposed implementation regulations that would allow whistleblowers to report a fraud within their company first (followed by contacting the SEC within 90 days) and still be eligible for the financial award. With this provision, companies who receive a whistleblower complaint internally have the opportunity to investigate matters themselves and self-report to the SEC on their findings.



### **What Can CFOs Do?**

So what can CFOs do to mitigate the potentially increased risks and costs of fraud allegations? According to the Association of Certified Fraud Examiners' 2010 Report to the Nations on Occupational Fraud and Abuse, 41 percent of frauds they studied at public companies were detected by tips. This suggests one approach to improving fraud detection is to enhance the performance of the company's whistleblower system to get additional useful tips. We believe this can also be complemented by a second approach to enhance transaction monitoring, such as through data mining and continuous auditing, in order to detect potential violations in other ways. In addition, it can be helpful to improve internal controls by enhancing antifraud training, especially focused on the finance function, and by putting in place pre-planned responses to fraud allegations.

#### ***Tuning up internal whistleblowing systems***

In the Dodd-Frank era, tuning up whistleblower systems may help to avert the costs of larger penalties and major regulatory investigations. Benchmarking an existing system against industry data can help to identify how an organization's system performs in comparison to industry averages. After that, steps can be designed to improve system performance.

One challenge to enhancing the effectiveness of whistleblower systems is that responsibility for the system can be distributed across different functions. In larger and more sophisticated companies it may be under the auspices of the chief ethics and compliance officer or ombudsperson's office, but in others it may be overseen by the general counsel or someone in internal audit, human resources or security. Regardless, multiple departments have an interest in the operation of the whistleblower system so improving it will typically require coordination and agreement among them all.

Despite the potentially huge payoffs from reporting fraud to the SEC, history shows many whistleblowers are motivated by principle rather than money. This is why many identify themselves despite the fact that whistleblowers historically have frequently been treated poorly by their organizations. By improving whistleblower systems to generate more whistleblower reports

internally, companies may be able to reduce costs arising from regulatory investigations, fines and penalties, as well as the costly reputational damage that can arise from unexpected reports of wrongdoing.

#### ***Tune up transaction monitoring for fraud detection***

Another approach to fraud detection and avoidance is to improve the monitoring of transactions to help accomplish compliance with ethical and legal standards. In addition to human internal auditing of transactions, today software tools enable rule-based tests and other anomaly detection procedures on transactions. Indeed, technology such as data mining or analytics tools is increasingly prominent in fraud detection given the high volume of transactions in many organizations. These tools are already being applied to transaction monitoring for anti-money laundering purposes and fraud detection in industries such as financial services.

However, efficient transaction monitoring or continuous auditing depends upon a strong infrastructure that enables data access at the transaction level. Common computer systems or accounting systems also facilitate data access for transaction monitoring. For instance, the CFO of a major business unit of a global, multi-billion dollar company found that one of the key benefits she achieved from integrating the computer systems of multiple sub-units was that she and her team could now view transaction-level data in each operating unit. This enhanced the effectiveness and efficiency of their monitoring activities to help ensure that revenue recognition was appropriate and that people in remote locations weren't playing games to meet revenue goals. Thus investments in systems integration can produce additional benefits in helping to mitigate fraud risks.

One potential cost of technology-based transaction monitoring is 'false positives' and the human cost of following up and investigating such false alarms. False positives are inherent in predictive tools, just as smoke detectors may periodically sound an alarm due simply to burnt toast. The key is to tune the system to strike a prudent balance between false positives and undetected frauds. So it is important to learn and improve the automated monitoring processes continuously.

### ***Boosting internal controls***

In the case of fraud, process-level internal controls typically get overridden, especially by managers and executives. But having strong and appropriate anti-fraud controls, especially entity level enterprise-wide controls, can reduce fraud risks and increase the likelihood of fraud detection. Today, increasing globalization and business units in emerging markets can contribute to heightened fraud and compliance risks. Based on the risk profile of specific emerging markets and business units, CFOs can selectively strengthen anti-fraud controls. This might include enhanced fraud, bribery and corruption awareness training for local personnel, increased monitoring by head office or regional management, and additional focused internal audit testing. Strong internal controls within the financial reporting process can also help to keep market-sensitive financial information confidential and reduce the risks of insider trading violations.

### ***Establishing consensus on efficient responses***

The Dodd-Frank legislation can be expected to boost whistleblower activities and the number of fraud accusations a company confronts and investigates. As this threatens to drive compliance costs up, particularly for larger multi-national companies, CFOs may wish to consider the potential budgetary impact. Furthermore, they can work with their general counsel to implement risk- and cost-management strategies such as establishing efficient protocols for investigations, sourcing in advance the resources to be used when issues arise anywhere in the enterprise, and developing 'playbooks' to help drive a focused and effective response in an emergency. Because the worst time to plan your response to a crisis is likely to be when you are in one.

For further information see: [Whistleblowing and the New Race to Report](#) which discusses ten steps organizations can take to enhance their whistleblower systems and help mitigate their risks in light of the Dodd-Frank Act and 2010's changes to the U.S. Federal Sentencing Guidelines.

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