

The Risks of Taking a Minimalist Approach to Corporate Hotlines

By Donald V. Jernberg
Attorney, Jernberg Law Group

February 28, 2006

Given the array of new requirements and associated costs created by the Sarbanes-Oxley Act (SOX) and related regulatory mandates, many companies have taken a minimalist approach to implementing employee reporting programs. SOX section 301 merely requires the board of public companies to implement “a program” for the reporting by employees on suspected financial misconduct. The only clear requirements are that anonymous reporting must be accommodated and records of reports maintained. The Federal Sentencing Guidelines expand the requirement to include all companies, not just those publicly traded, and any illegal conduct, not only financial matters. With such limited expressed requirements, a telephone reporting system, either internal or external, a web based electronic system, or even a simple mailing address might support checking the “in compliance” box for a corporate reporting system. However, such a minimalist approach creates significant risk to the company and its directors.

Automobile manufacturers were first required to simply have seat belts, but eventually some manufacturers added front airbags before they were required. Now side impact airbags are being added by some manufacturers before being required. Car and other manufacturers have learned that just meeting the minimal standard still leaves them exposed to potentially serious claims. Those charged with implementing corporate reporting programs should heed the lesson learned by many product manufactures.

The Association of Certified Fraud Examiners estimates that companies lose 6% of their revenue annually to fraud. A Deloitte survey of 459 companies with revenues in excess of \$500,000,000 found that 7% had suffered financial fraud last year, with average losses of over \$25,000,000. An Ernst and Young study found that 50% of 300 global companies uncovered at least one major fraud event in 2002. Fraud and misconduct occur. The Association of Certified Fraud Examiners and others have also found that an “employee tip line” is the most effective means of discovering fraud and reducing its impact through earlier detection. The value of having a reporting program is clear. The importance of having a robust program also needs to be understood. The following is a brief outline of some points to consider.

- Internally controlled systems carry the risk that those in charge may be pressured to dilute the contents of reports; that it can be more credibly alleged that the insiders manipulated the report; a failure to appreciate the facts and respond accordingly can be made to appear like a cover up. Employees may be reluctant to use a system viewed as controlled by management – a significant survey found that only 49% of employees thought their management personnel were people of high integrity and only 62% believed that management would not support illegal or unethical conduct. An internal system may not convey a message that senior management is committed to a serious reporting program. Smaller companies will also face implementation challenges with an internal program.

- Neither internal nor many currently available reporting programs offer a good method of following up with an anonymous tipster. The current follow up protocol is typically to ask the informant to call back or log back into a web based system to receive follow up questions, but about 50% do not call back. The ability to proactively follow up may be critical in some cases in order to promptly and properly assess a situation to best focus an investigation in a cost effective manner. An anticipated 50% failure rate is simply not acceptable. Even if the informant calls back, he or she will be connected to a random operator who, with no background in the matter, can only read pre-scripted questions. Again, not a satisfactory solution.
- Employees working in fraud-sensitive areas, such as accounting, or with senior management may need not only special training but also a special reporting system and support to encourage reporting. Eighty-seven percent of the public expect whistleblowers will suffer retaliation and 70% in fact do suffer it. Getting employees to report concerns on potentially complex matters likely involving senior management will require extra effort, commitment, and support for the employees. A one-size-fits-all approach may be effective in getting people to report human resource issues but cannot be expected to be equally as effective in getting the whistle blown on members of senior management who are in a position to create major harm to the company.
- Smaller companies and not-for-profit entities may not have the legal and accounting resources internally to properly analyze, direct, and suggest follow up on initial reports. These entities, and perhaps even larger companies, may well need integrated analytical services that can properly assess the incoming reports and get management or the board making the right response and follow-up decisions.

The above are just some examples of the issues and questions that need to be addressed in implementing an effective, as opposed to a minimally compliant, reporting system. Each company's needs, capabilities, and risk profile will be different. The reporting system should be flexible and customized in order to deliver the value that an effective program can bring. The incremental cost of implementing a strong program versus a minimal one will be minor compared to the extra protection provided. Engineers who put side airbags and extra safety features into their cars are protecting both the customers and the company. Those charged with implementing corporate reporting systems will protect both the company and the shareholders by not accepting minimal compliance.

Donald Jernberg manages the Jernberg Law Group in Chicago, which offers services to companies in implementing effective corporate reporting programs. He can be contacted for information or questions at: djernberg@jernberglaw.com or 312-899-8011.

This is an article reprint from the Governance Issues™ Newsletter, Volume 2006, published on February 28, 2006

The Governance Issues™ Newsletter is meant to be distributed freely to interested parties. However, any use of this article must credit the respective author and Candela Solutions LLC as the publisher. All rights reserved. Use of the newsletter article constitutes acceptance of our [Disclaimer](#) and [Privacy Policy](#).

To automatically receive the newsletter, go to www.CandelaSolutions.com and register. Or, send a request to newsletter@CandelaSolutions.com and we will register on your behalf.