



WHITEPAPER

Strength in Numbers

*The ROI of Compliance Program
Hotline Reporting*

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INTRODUCTION

Corporate ethics and compliance officers have long sought to quantify the business value of internal hotline reporting systems. Of particular interest is a means to accurately calculate the financial return these systems deliver to the bottom line.

Historically, compliance professionals have believed in a link between hotline usage and better business performance: that a strong speak-up culture not only helps the business achieve regulatory compliance; it also provides a strategic competitive advantage in the marketplace. That belief is supported primarily by anecdotal evidence and intuition from years of practice. Compliance officers had little empirical data directly associating internal reporting with business performance. **Until now.**

A groundbreaking new study out of George Washington University, *Evidence on the Use and Efficacy of Internal Whistleblowing Systems*¹, examines the relationship between internal reporting system usage (whistleblower hotlines) and business performance. To conduct this study, the researchers requested, and were granted, access to the industry's largest internal whistleblowing database. This data is maintained and administered by NAVEX Global, the market-leading provider of whistleblower hotline and incident management systems. Kyle Welch, lead researcher, noted, "The NAVEX Global data set was uniquely valuable to this work as it is the only one of its size, the largest by far. Additionally the records go back more than a decade, which enabled us to see changes over time."

After a rigorous vetting process, the researchers were given secure, anonymized access to more than 3 million internal report records from approximately 5,000 public companies – including more than half of the Fortune 500. Visibility was limited to specific data fields, and the confidentiality of the report content was strictly maintained. No personally or company-identifiable information is included in this report. The data examined includes hotline reports over a fourteen year period, 2004 – 2017.

KEY FINDINGS

There is a correlation between increased use of internal reporting systems and improved business performance.

¹ Stubben, Stephen and Welch, Kyle T., *Evidence on the Use and Efficacy of Internal Whistleblowing Systems* (October 26, 2018). Available at SSRN: <http://ssrn.com/abstract=3273589>

KEY FINDINGS

*The data shows that hotline reporting activity and return on assets are always correlated positively: **the more activity, the greater the ROA.***

EXECUTIVE SUMMARY

The study reveals a clear correlation between increased use of internal hotline reporting systems and improved business performance across several important dimensions. This statistical validation is welcome news for compliance professionals, executive leadership, and others concerned with maintaining a healthy, productive workplace culture.

Several of the study's findings are counter-intuitive. For example, prior to this research, one might assume that more internal reporting suggests a troubled, possibly toxic corporate culture. In fact, the opposite is true: more internal reporting correlates to better business performance.

Further, the study also finds that those benefits increase with usage. That is, the more an organization uses its hotline, the more certain business results improve. Specifically, increased hotline use is correlated with:

- » **Greater profitability and productivity** as measured by return on assets (ROA), a commonly used financial productivity metric. Companies with higher levels of reporting activity had ROA as much as 2.8 percent higher than comparable companies with lower levels of hotline activity.
- » **Fewer material lawsuits.** Companies with higher levels of reporting were subject to 6.9 percent fewer pending material lawsuits in the subsequent three years than those with lower levels of activity.
- » **Lower litigation costs.** When material lawsuits were brought against companies, those with higher hotline usage faced 20.4 percent less in total settlement amounts.
- » **Fewer external whistleblower reports.** Companies with more internal reporting activity experienced fewer external reports to the Occupational Health & Safety Administration (which receives whistleblower reports under Section 806 of the Sarbanes-Oxley Act) in subsequent years.

The research also found that lower levels of hotline activity were associated with suspect corporate governance and financial reporting.

Specifically, lower hotline use is correlated with:

- » **Weaker governance practices.** Companies with lower-level hotline activity rated poorly on the [Bebchuk Entrenchment Index](#). This index measures governance practices such as staggered boards, limited shareholder rights, and golden parachute payments for senior executives; all of which correlate to lower firm valuations.
- » **Increased potential for earnings management.** Firms with lower-level hotline activity also tend to claim “discretionary accruals” (an indicator of earnings management) more often. Further, companies with more discretionary accruals, also tended to see more external whistleblower reports in subsequent years.

These conclusions were reached in two steps. First, the researchers measured how much organizations use their reporting systems. This was defined by criteria such as number of reports submitted per employee, average number of times each case file was accessed and reviewed by management, and the portion of data fields filled in by the reporter rather than left blank. Then, those variables were compared to the fourteen year data set of reports provided by NAVEX Global.

This first-of-its-kind-report sheds new light on how a robust internal reporting system helps management improve both workplace culture and business results simultaneously.

IN DETAIL: THE POSITIVE FINDINGS

KEY FINDING #1



Higher ROA

Companies with higher hotline usage have ROA up to 2.8% higher than similar companies with lower hotline usage.

1. Hotline usage and greater return on assets.

The study finds that companies with higher levels of reporting activity also enjoyed higher return on assets (ROA) relative to their peers. ROA is a standard measurement (net income divided by total assets) of how efficiently a company uses its assets to generate profits, and can also serve as an indication of overall productivity.

The analysis shows that firms at the high end of hotline usage have ROA up to 2.8 percent higher than similar companies with low reporting activity. One logical explanation for this positive difference is that well-run companies with high return on assets also encourage reporting. Alternatively, it could be that companies with more activity have a more engaged, productive workforce.

Regardless, the data shows these factors always correlate positively: the more reporting activity, the greater the ROA upward adjustment. Interestingly, the analysis did not identify any point of diminishing returns; there is no point beyond which more hotline activity begins to correlate with lower ROA.

KEY FINDING #2



Fewer material lawsuits

Companies with higher hotline usage experience 6.9% fewer material lawsuits over a three-year period relative to similar companies with lower hotline usage.

2. Hotline usage and fewer material lawsuits.

Increased hotline activity is associated with fewer material lawsuits filed against the company, both in the immediate and near-term future. The study examined hotline activity in a given year and compared it to material lawsuits filed against the company in subsequent years, up to three years out. Those lawsuits ranged from sexual harassment claims, to allegations of accounting impropriety, to qui tam lawsuits brought under the False Claims Act.

The result: companies with higher hotline activity experienced 3.9 percent fewer pending material lawsuits in the following year, improving to 6.9 percent fewer lawsuits over the subsequent three years. **Companies that had more management attention to reports (for example, compliance program administrators viewing the file more often, or evidence of gathering more information) had even fewer lawsuits.**

3. Hotline usage and lower litigation settlement costs.

Likewise, firms with higher hotline activity also saw smaller legal settlement amounts than low-activity peer firms: 8.9 percent smaller settlements in the following year, and 20.4 percent smaller in settlements across the subsequent three years.

These correlations hold true even after controlling for several variables that can affect a firm’s litigation risk. For example, larger firms generally face more lawsuits, and settlement amounts are likewise larger. The fundamental conclusion is always the same: more internal reporting activity correlates to fewer lawsuits and lower litigation settlement amounts, once those other factors (like firm size) are accounted for.

This suggests that high internal reporting activity allows companies to resolve problems before they reach the point of a lawsuit – that internal reports are, as Welch phrases it, “the last stop” before an employee goes to regulators or outside counsel with his or her concerns.

KEY FINDING #3



Lower settlement costs

Companies with higher hotline usage see 20.4% smaller litigation settlement costs over a three-year period relative to similar companies with lower hotline usage.

IN DETAIL: THE NEGATIVE FINDINGS

Lower hotline usage and more discretionary accruals. Discretionary accruals are judgments and estimates a company's management makes about cash flows. Those decisions are not bound by specific accounting rules, and previous academic research has found that greater use of discretionary accruals is associated with earnings management, and even manipulation.

The study found that companies with more discretionary accruals tend to use internal reporting systems less; and that firms with more discretionary accruals in one year also tend to have more external whistleblower reports (as designated under Section 806 of the Sarbanes-Oxley Act) in the following year.

The research only documents the **correlation** of these factors. It could be that companies with high internal hotline activity are better at policing against trouble, and therefore discourage earnings manipulation. It's equally plausible that companies engaged in aggressive earnings management also discourage use of the internal hotline.

However, the correlation is there: **lower** hotline activity indicates **more** use of discretionary accruals. Therefore it also logically follows that such companies might experience more external whistleblower activity, since SOX Section 806 gives employees a protected way to report earnings management and other accounting impropriety to regulators.

Lower reporting activity and poor corporate governance. The study also looked at a subset of companies in the S&P 1500 to compare their internal reporting activity to the [Bebchuk Entrenchment Index](#).

The Entrenchment Index is a corporate governance benchmark created by Harvard Business School professor Lucian Bebchuk to assess governance practices such as staggered terms for board directors, limited shareholder rights, and golden parachute payments for senior executives; which all correlate to lower firm valuations.

The study found that firms with weaker corporate governance also had lower internal reporting activity than their strong-governance peers. Logically that makes sense: a firm with poor governance practices is likely to have strong executives able to stifle dissenting voices (that is what the Bebchuk Index measures), therefore those firms are likely to use reporting systems less often. This study's analysis supports that hypothesis.

IMPLICATIONS

Hotline reporting tells the company how eager its employees are to raise and discuss problems. It is a measure of engagement in the long-term success of the company, both financially and strategically.

IMPLICATIONS: WHAT'S NEXT FOR COMPLIANCE OFFICERS

Foremost, this research dispels the notion that more internal complaints are inherently bad. They are not. The data shows that higher internal whistleblower activity **never** correlates with negative business outcomes.

The data shows that hotline activity does more than predict future concerns about potential litigation or regulatory investigations. ***This metric tells the company how eager its employees are to raise and discuss problems.*** It is a barometer of their engagement in the long-term success of the company, both financially and strategically.

On those grounds alone, boards should be demanding this data – and compliance officers should be glad to provide it; it's a crucial metric of business performance across several definitions of the term: higher return on assets, lower levels of litigation, smaller legal settlements. Once upon a time, boards and senior executives might have assumed hotline activity above some arbitrary threshold was bad. This data shows the opposite. That is, more hotline reporting activity always correlates to better business performance among the criteria measured in this study.

The research also has implications for a company's efforts to improve its corporate culture; to achieve a true "culture of compliance." If hotline activity measures employees' willingness to raise and discuss problems, then tracking that reporting activity as a metric itself – month after month, quarter after quarter – reveals how much more or less willing employees are to raise and discuss problems over time. It measures how the organization's sensitivity to ethical conduct might be changing.

For example, if a company sees a sudden spike in hotline reports it **can** mean the company is experiencing some new wave of misconduct; or perhaps the level of concern has always been there, but something prevented employees from speaking up. Compliance officers would need to investigate that question.

However, a spike in reports **does** mean that employees are more willing to raise the issue. In turn, that willingness to raise issues shows that the company's efforts to drive a culture more attuned to ethical concerns is succeeding. And this new research suggests that the increase in reports is a positive for the organization.

A healthy, ethical culture pays off in many ways. This research offers compliance professionals a new way to measure program effectiveness, and shines a new light on the implications of hotline report statistics. Compliance officers can also show their executive leadership and the board that hotline reporting is far more valuable than previously considered, regardless of regulatory requirements. And that increased activity **has value beyond the reports themselves.**

Fundamentally, compliance officers now have the first empirical evidence of something that has always felt right: that investing in compliance brings a strategic advantage to the organization. It helps companies to identify and resolve problems more quickly, which translates into fewer external complaints to regulators, fewer lawsuits, and lower legal settlements.

Those are the advantages a company gains not just by talking about ethics and good conduct, but by investing in the policies, procedures, training, third-party due diligence, and other compliance program activities to generate more internal activity. Even if the Justice Department, the U.S. Sentencing Guidelines, and compliance program examinations all vanished tomorrow, the evidence now exists that companies should still embrace compliance programs and internal whistleblowing anyway, because they improve organizational excellence.

On a practical level, these findings can guide a compliance officer's thinking about how to build and operate a compliance function. The primary conclusion – that more internal reporting activity is better – becomes the fixed point on the horizon companies want to reach. This also suggests that hotline data should be treated as a key performance metric and regularly be reported to the board.

To generate and administer more reports, compliance programs must build a system to receive them via multiple channels (including, especially, employees bringing concerns directly to managers); and a system to shepherd those reports from filing to investigation to resolution; and then consolidate that data from all systems into one larger picture. That's the only way to get a complete analysis of activity that gives useful information to senior management.

The findings also raise an interesting point about hotline reporting policy: if more activity is better, then companies should encourage a duty to report; they may even want to devise performance review policies that encourage reporting (or at the very least, actively discourage and prevent retaliation against reporters).

Since some employees or third parties will always feel uneasy about reporting under their own name, a means of anonymous reporting will still be a vital part of the hotline/reporting toolkit. So compliance officers will need to consider how to convey both points (a duty to report, and the availability of anonymous reporting) in training and awareness materials, and executive communications.

Compliance professionals should continue from there, exploring how this research has implications for program management, policy, training, data collection and more. The key point: compliance officers no longer need to wonder how much activity is “enough.” More internal reporting activity is always better.

IMPLICATIONS

Companies with fully implemented, actively advertised, and widely used internal reporting systems benefit from a flow of information from employees, thus being in a position to more quickly identify and rectify problems before they become larger and more costly to the company.

DATA BY HISTORY AND INDUSTRY

The GWU researchers studied internal hotline reporting data from 2004 through 2016. Even those raw numbers provide fascinating glimpses into how reporting activity and speak up culture have evolved over time and across industries.

For example:

- The number of reports per 1,000 employees rose from 5.83 to 15.74 over the time period examined;
- The amount of detail contained reports more than doubled, from 22 to 46 percent, as measured by report form data fields completed;
- The average number of times a report is accessed by a program administrator before it is closed has remained steady at around 11.

Reporting activity by industry also varied greatly. In the computer and food industries, reports per 1,000 employees were at 5.55 and 6.84, respectively. Meanwhile, the rates were much higher in utilities (26.01), pharmaceuticals (19.87), and extractives (19.70).

None of those trends should be surprising. The rise in employee reporting over time corresponds to growing awareness of corporate compliance programs, as well as the proliferation of hotlines and other mechanisms so employees can speak up.

Higher activity in energy, pharmaceuticals, and mining is not news to any compliance professionals in those industries. In all three sectors, sales contracts are often complex and ripe for manipulation. Buyers are often government agencies, which triggers compliance risk around the Foreign Corrupt Practices Act or the False Claims Act. One would expect to see more internal reports when the potential for misconduct is intrinsically higher.

ABOUT NAVEX GLOBAL

NAVEX Global’s comprehensive suite of ethics and compliance software, content and services helps organizations protect their people, reputation and bottom line. Trusted by 95 of the FORTUNE 100 and more than 13,000 customers, our solutions are informed by the largest ethics and compliance community in the world.