How Corporate Culture Can Silence the Whistle

Lessons Learned from Volkswagen's Dieselgate (CS 1-5)
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What we should know about VW (1/3)

• Volkswagen is based in Wolfsburg, a city with about 123,000 inhabitants, which was founded in 1938 because of Volkswagen.

• A specific law guarantees the German state of Lower Saxony, as Volkswagen’s second-largest shareholder specific voting rights.
What we should know about VW (2/3)

• Volkswagen is well known for a powerful workers’ council.
• In 2013 Volkswagen was elected as No.1 employer in Germany.
• Volkswagen has a mature compliance system with an external whistle-blower hotline, code of conduct and an internal audit department.
One main element of corporate governance is corporate culture. Research points out, that culture is important and directly connected to the value of the company.
Corporate culture can be defined as “the mechanism that delivers the values and behaviors that shape conduct and contribute to creating trust in [organizations] and a positive reputation for [organizations] among key stakeholders, both internal and external.” (G30, (2015), p.17).
Corporate Culture (3/3)

• Employees place a high priority on workplace culture and an interesting, meaningful work.
• Top ranked employers seem to be seen as organizations with a mature corporate culture.

• These organizations deliver benefit for their employees and increase the value of the job.
• The higher ranked an employer is, the more difficult it is to get a job there because many people like to work there.
Internal auditors have to include corporate culture in their audit universe and perform audits on corporate culture.
Some aspects of the audit can be:

- employee and customer survey results,
- comprehensive training programs for employees,
- protection of whistle-blowers,
- strong leadership, shared values and
- trust and openness.
Four types of fraudsters (1/6)

• Differentiate between a direct/indirect benefit or access to money as one factor.
• Someone has a direct benefit, if he participates without any delay. If a pickpocket steals money from a colleague he can use the stolen money right afterwards: cash in his pocket.
Four types of fraudsters (2/6)

• A fraudster has indirect benefit, if his fraudulent action leads to a profit for his company and as an effect he gets an additional bonus: cash in the companies pocket and then in his pocket.
Four types of fraudsters (3/6)

- The second factor is the sort of contract in connection to the fraudulent act. If a fraudster agrees willingly to a fraudulent act, he signs an active contract.
- With a passive contract he participates in the fraud without any action.
### Four types of fraudsters (4/6)

<table>
<thead>
<tr>
<th></th>
<th>Direct benefit</th>
<th>Indirect benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Active contract</strong></td>
<td>Fraudster A</td>
<td>Fraudster B</td>
</tr>
<tr>
<td><strong>Passive contract</strong></td>
<td>Fraudster C</td>
<td>Fraudster D</td>
</tr>
</tbody>
</table>
Four types of fraudsters (5/6)

• Fraudster A steals money from a colleague.
• Fraudster C knows about the origin of the money. He benefits from fraudster A via an invitation to an event.
• Fraudster C is the potential whistle-blower.
Four types of fraudsters (6/6)

• Fraudster B manipulates the financial statement.

• Fraudster D participates in the fraud, while he earns an additional bonus because of the high profit shown in the financial statement.

• Fraudster D is the potential whistle-blower.
Objectivity as rational behavior (1/2)

- Standard 1100 states: „Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. …
Objectivity as rational behavior (2/2)

• … Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.”

• The IPPF expects internal auditors to act strictly objective, in other words: rational.
The game (example)

<table>
<thead>
<tr>
<th>FIFA 2014 Final game</th>
<th>Romero decides to defend right side</th>
<th>Romero decides to defend left side</th>
</tr>
</thead>
</table>
| Götze decides to shoot on right side | Götze: 0  
Romero: 1 | Götze: 1  
Romero: 0 |
| Götze decides to shoot on left side | Götze: 1  
Romero: 0 | Götze: 0  
Romero: 1 |
The employee – employee - game

- 2 Colleagues.
- Both know about the fraud.
- Both know, that the other knows about the fraud.

### Payoff Matrix

<table>
<thead>
<tr>
<th></th>
<th>MA 1 active q</th>
<th>MA 1 passive 1 – q</th>
<th>MA 2 active p</th>
<th>MA 2 passive 1 – p</th>
</tr>
</thead>
<tbody>
<tr>
<td>active</td>
<td>( K - \mu \cdot (AV + KR) - AW - OE )</td>
<td>0</td>
<td>( K - \mu \cdot (AV + KR) - AW - OE - SO )</td>
<td>-( \mu \cdot (AV + KR) + K - AW - OE - SO )</td>
</tr>
<tr>
<td>passive</td>
<td>( -\mu \cdot (AV + KR) + K - AW - OE - SO )</td>
<td>( -\beta \cdot (AV) - S )</td>
<td>( -\beta \cdot (AV) - S )</td>
<td></td>
</tr>
</tbody>
</table>
Payoff function (1/8)

- A short term risk of being fired because of whistle-blowing.
- A long term risk of not getting an equal job, because employees may not want to hire a whistle-blower.
Payoff function (2/8)

• Costs for a lawyer because there will be conflicts with the employer or appearance as a witness in a trial.

• The media will give attention. This will lead to costs of public interest.
• Education is an investment in oneself and people move to the place where the employer is based.
• The social network has to be rebuilt. The first points of contact are colleagues from the company.
Payoff function (4/8)

• If he blows the whistle he will face social exclusion in his neighborhood, because friends work for the same company and children attend the same school.

• This is especially a problem, where a whole area is dominated by one big employer.
• If he blows the whistle, he will be seen as a key witness and can realize a sort of protection.
• Sometimes there is a monetary incentive.
Payoff function (6/8)

• All the elements shown can be found when the employee blows the whistle and discloses the hidden information.
Payoff function (7/8)

• If he is quiet – and later all will be revealed – he is ashamed, because he kept secret and will be blamed by others.

• He is at risk regarding his job, because he can’t be sure whether he will be made responsible as a fraudster type D (indirect/passive).
• In the staff game both players (MA 1 and MA 2) have the same payoff function.
• The passive one could be seen as more loyal than his active colleague.
Internal Audit performs an Audit on corporate culture

- with significant findings and relevant recommendations and
- Top management is very interested and decides to take action.
As a result

- a hot line is implemented,
- a training program is launched and
- the protection of whistle-blowers is enhanced.
• This will lead to a better whistle-blower protection and the employees feel safer now regarding their job while whistle-blowing.

• We can see that the audit report improved corporate culture.
And because of the effect that corporate culture is positively related to the value of the job, the value of jobs increases as well: as a result high potentials are more willing to work in this company.
The audit on culture (5/7)

• Some elements of the employee’s payoff function are exogenous factors, while other elements can be influenced by corporate measures.
The audit on culture (6/7)

- Risk of being fired: \( \mu \cdot (-AV) \)
- Risk of not getting an equal job: \( \mu \cdot (-KR) \)
- The factor \( \mu \), with \( 0 \leq \mu \leq 1 \), is the probability of being fired.
- Protection of the whistle blower: (+K) [Sometimes a monetary incentive]
• If the value after the audit
\[ K_1 - \mu_1^*(AV_1 + KR_1) \]
is higher (>) than before the audit
\[ K_0 - \mu_0^*(AV_0 + KR_0) \]
we have a better environment for corporate whistle-blowing.
Before the audit …

Risk of being fired: $\mu \cdot (-AV=-10)$
Risk of not getting an equal job: $\mu \cdot (-KR=-15)$

The factor $\mu=0.60$, with $0 \leq \mu \leq 1$, is the probability of being fired.

Protection of the whistle blower: (+K=16)

$[K_0 - \mu_0 \cdot (AV_0 + KR_0)] = [16 - 0.60 \cdot (10 + 15)] = 1$
After the audit …

A better whistle-blower protection: (K=20) with + 4
The employees feel safer now: (μ=0.55) with - 0.05
The value of jobs increases as well: (AV=16) with + 6 and (KR=21) with + 6
... we get a surprising result

A better whistle-blower protection: \((K=20)\)

The employees feel safer now: \((\mu=0.55)\)

The value of jobs increases as well: \((AV=16), (KR=21)\)

\[
[K_1 - \mu_1*(AV_1 +KR_1)] =

[20 - 0.55*(16+21)] = -0.35
\]
The governance’s dilemma (1/2)

• A strong corporate culture leads to a high job value.

• As worst case a strong corporate culture will help to cover the fraud because the employee isn’t willing to blow the whistle.
The governance’s dilemma (2/2)

- We have to differentiate between corporate governance and the payoffs of an individual employee.
- In our case the employee behaves according to his payoff function.
- The payoff function of the organization has no relevance for him.
To take home (Conclusion II)

• No easy answers on Corporate Culture
• Don’t judge by the results: mind the gap
• Don’t assume all employees are brave actors – literature tells us another story
• Carry on auditing culture: why not using game theory?
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Member of the International Internal Audit Standards Board
Backup


Literature (3/3)