

The audit committee's evolving role in overseeing corporate investigations



Building a better
working world

SQUIRE 
SANDERS





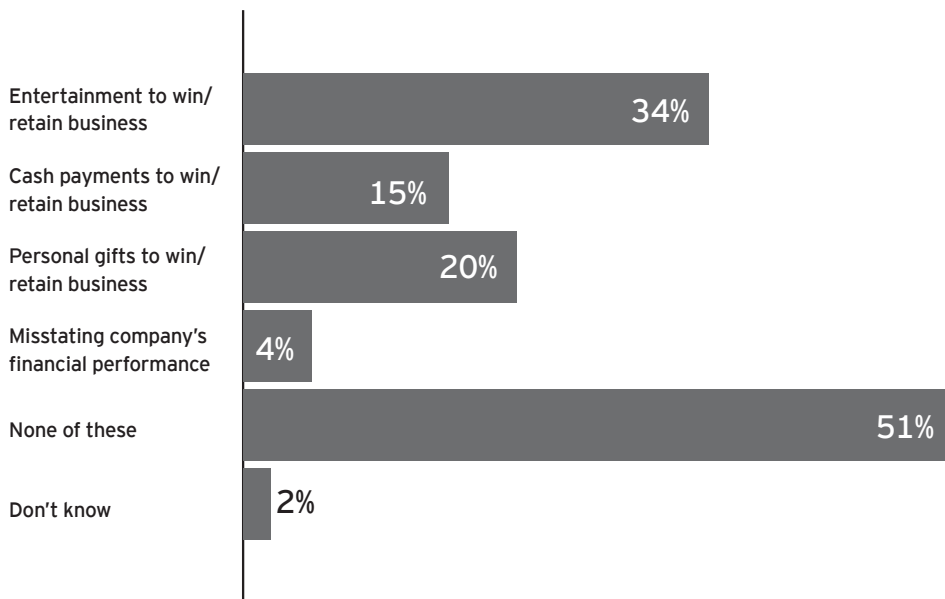
During the past decade, a confluence of economic, political, legislative and regulatory forces have created an environment in which internal investigations of corporate behavior have become increasingly common. Internal investigations are generally directed by company personnel or members of the Board of Directors. Independent reports indicate that during 2007, 40% of all US public companies were involved in some type of internal investigation. For the largest US public companies, that percentage exceeded 70%.

With the enactment in 2010 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), the increase in whistleblower claims filed in its wake and the downturn in the world economy, few public companies will escape the need to conduct an occasional internal investigation, and companies in certain sectors will face such activity on a recurring basis.

While not all corporate investigations involve financial or other matters within the audit committee's province, audit committees nonetheless reluctantly find that they are managing more frequent internal investigations – some of them quite extensive.

This spike in internal investigative activity comes at a time of heightened regulatory scrutiny amid a flurry of record fines and penalties for corporate infractions. Both the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) have stepped up the pace of their enforcement efforts, and senior SEC enforcement staff members have publicly stated that the agency now commonly focuses not solely upon corporate misconduct, but also evaluates the behavior of “gatekeepers” such as accountants, in-house attorneys and board members.

CFOs justify actions to help business survive downturn

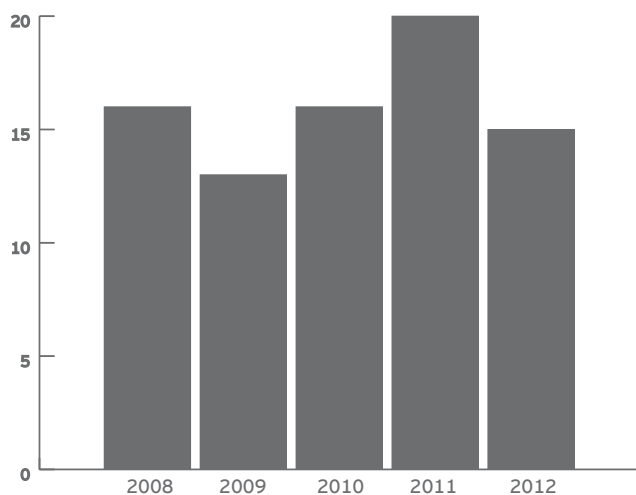


Q: Which, if any, of the following do you feel can be justified to help a business survive an economic downturn?

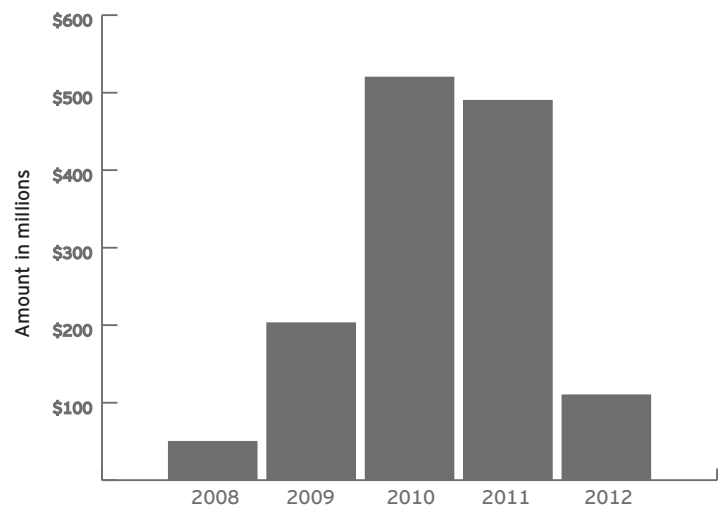
Base: all CFOs (372)

Ernst & Young, *Growing Beyond: a place for integrity, 12th Global Fraud Survey*

Foreign Corrupt Practices Act (FCPA) actions brought by the SEC



SEC FCPA settlements



<http://www.sec.gov/spotlight/fcpa/fcpa-enf-acts-chart.pdf>

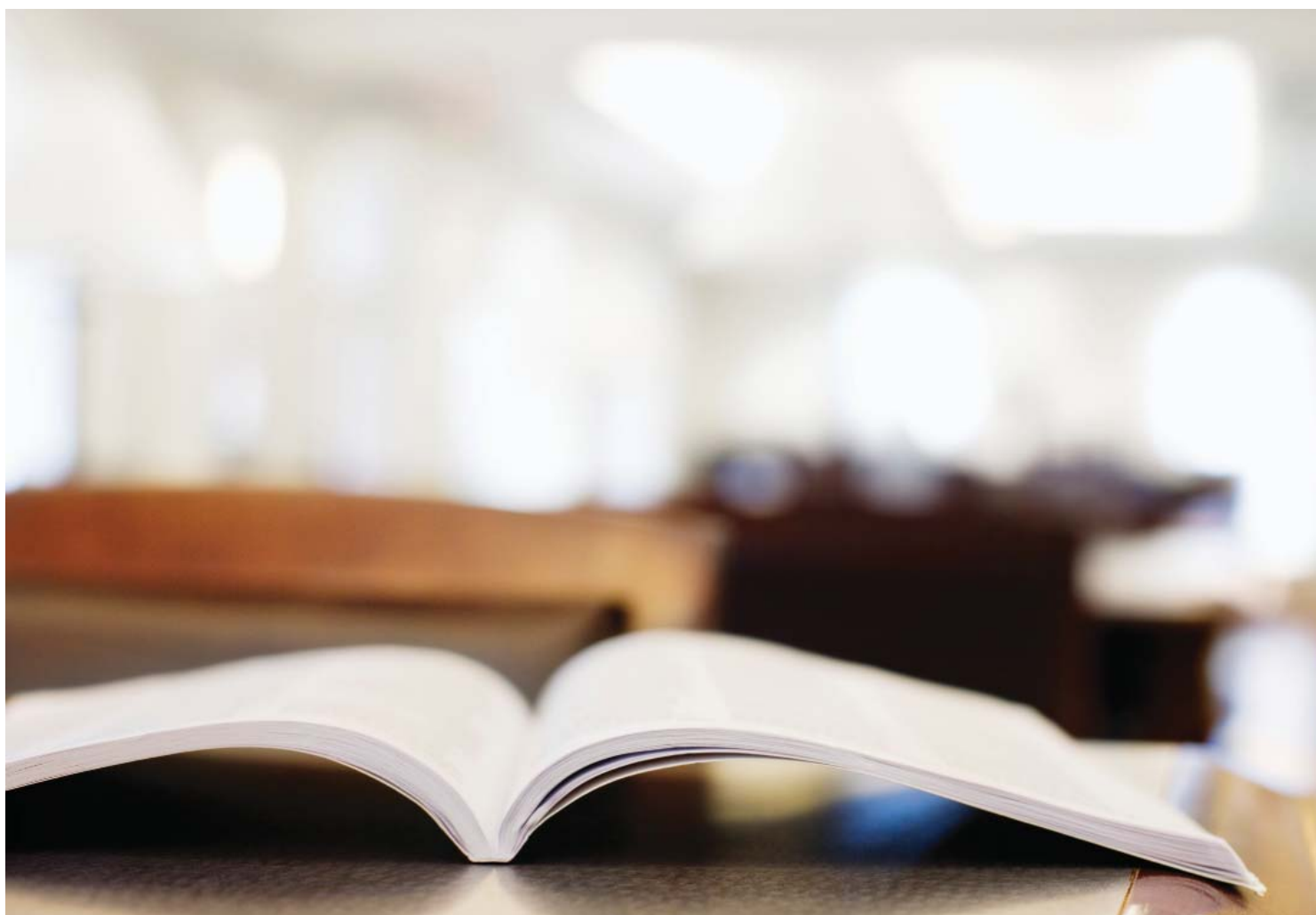
<http://www.sec.gov/spotlight/fcpa/fcpa-cases.shtml>

Enforcement action by fiscal year	2008	2009	2010	2011	2012
Broker-dealer	67	109	70	112	134
Delinquent filing	113	92	106	121	127
FCPA	n/a	n/a	n/a	*20	15
Financial fraud/issuer disclosure	154	143	126	**89	79
Insider trading	61	37	53	57	58
Investment adviser/investment co.	87	76	113	146	147
Market manipulation	53	39	34	35	46
Security offerings	115	141	144	124	89
Other	21	27	35	31	39
Total enforcement action	671	664	681	735	734

*Prior to FY 2011, FCPA was not a distinct category and FCPA actions were classified as Issuer Reporting and Disclosure.

**Prior to FY 2011, this category was reported as Issuer Reporting and Disclosure and included FCPA actions, which are now tracked separately from financial fraud/issuer disclosure actions.

<http://www.sec.gov/news/newsroom/images/enfstats.pdf>





Given these factors, the stakes have never been higher for audit committee members overseeing an internal investigation. Furthermore, as several recent cases have illustrated, a flawed investigation can actually make matters worse for the corporation, while creating reputational and legal risks for the directors themselves.

It can be argued that a committee of part-time board members selected for their general business and financial acumen is neither designed nor equipped to undertake such a frequent and intense investigatory role. Reality, nevertheless, dictates that audit committee members understand how they will be judged when deciding whether to commence an internal investigation, how it should be conducted, who should be involved, how and when findings should be reported, and what, if any, remedial actions should be taken.

Establishing the framework for the investigation

Unlike a typical internal audit which casts a broad net and may not be targeted at any particular suspicious activity, an audit committee investigation is normally focused upon specific events or allegations. Where the audit committee charter grants to the audit committee oversight of other corporate activities (such as related-party transactions), the matters to be investigated may not be of a purely financial nature. In some (but not all) instances, the issues under consideration will involve allegations of illegal conduct.

Depending on the nature and extent of the matters requiring investigation, audit committee members should give thought to whether a special committee of independent directors should be formed to conduct the investigation. Special committees can be beneficial in a number of ways but, specifically, they allow their members to focus on one charter or task. They can help directors avoid the confusion that may occur when they wear different hats and can leave the audit committee free to perform its regular responsibilities.

When illegality is potentially present, an internal investigation will sometimes occur in parallel with one or more government proceedings or investigations, requiring that care be taken to ensure that the internal investigation does not compromise the corporation's legal interests and that it is not viewed as impeding the government's inquiry. Understanding the context of the investigation will assist the audit committee in making crucial threshold decisions relating to the scope of the investigation, how and when it should be approached and who will conduct it.

While time is generally of the essence in making these initial decisions, the admonition of legendary basketball coach, John Wooden, to "be quick but don't hurry" is excellent advice for audit committee members at the outset of an investigation.

Common subjects and triggers for an audit committee investigation

An internal investigation is sometimes initiated by the audit committee based upon its own concerns. More often, investigations are triggered by external factors, circumstances or events.

Common subjects of audit committee investigations include:

- ▶ Improper accounting for business activities (e.g., manipulation of earnings), falsified books and records, stock option grant irregularities, etc.
- ▶ Illegal payments to obtain business (e.g., government contracts, FCPA issues and commercial bribery)
- ▶ Occupational misconduct, such as embezzlement or employee theft
- ▶ Conflict-of-interest or related-party transactions

Investigations can result from a number of sources. Some common triggers for an internal investigation are described in the chart below:

Complaints by whistleblowers or others	Since the Association of Certified Fraud Examiners (ACFE) began tracking this data in 2002, tips have been the most frequent method of fraud detection, with 43.3% of detected frauds in 2012 resulting from tips. ¹
Internal audit findings, internal control reviews, Sarbanes-Oxley assessments or similar control review procedures	According to the ACFE, 14.4% of occupational frauds detected in 2012 were uncovered by a company's internal audit function. ²
Reports from external auditors	According to the ACFE, 3.3% of occupational frauds detected in 2012 originated from the external auditors. ³
Management review/due diligence preceding an acquisition	Investigations can result from findings or suspicions developed during due diligence activity prior to a merger or acquisition. In addition to financial and operational due diligence, many companies now analyze FCPA and other anti-corruption issues elements of legal compliance when evaluating an acquisition target. Internal controls can also uncover suspicious activity that triggers the need for an investigation.
Lawsuits or other claims asserted by counterparties, vendors or customers	Claims asserted by outside parties account for 32.6% of the ACFE's occupational frauds detected through tips. ⁴
Governmental inquiries or subpoenas	According to the ACFE, during 2012, the most costly frauds – those with a median loss of US\$1 million – were detected by law enforcement agencies. ⁵
Other/press reports	<i>Wall Street Journal</i> writer Jonathan Weil was one of the first reporters to question Enron's accounting policies with his article. "Energy Traders Cite Gains, But Some Math Is Missing," published in September 2000.

¹ ACFE Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey, pg. 14.

² Ibid.

³ Ibid.

⁴ Ibid.

⁵ ACFE Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey, pg. 15.



Both the subject and the trigger of the investigation will bear upon a variety of decisions that the audit committee must make. Chief among them will be timing considerations, as the investigation may need to proceed quickly in order to respond to financial reporting deadlines, to meet governmental expectations, or to deal with public relations or other communications concerns. Understanding the cause and nature of the investigation will also inform the audit committee's judgment as to who should assist with the investigation, as well as in setting the scope of inquiry. For example, an investigation that results from a government inquiry is likely to be structured very differently than an investigation prompted by a discovery made during a routine internal audit.

Preservation of documents and records – a crucial first step

Regardless of the factors that lead to the investigation, it is imperative that all potentially relevant evidence is preserved. The failure to take steps calculated to preserve documentary evidence can impede a thorough investigation and can seriously compromise the company's legal position with regulators, or in any ensuing litigation.

Accordingly, at the outset of the investigation, the audit committee should work with the company's management and legal department to preserve documentary evidence. Normally, the first action will be the issuance of what is commonly referred to as a "document preservation notice" to an appropriate universe of employees, officers, directors, consultants or other third parties. The preservation notice should cover electronic, as well as paper, records.

Simultaneously with the issuance of the notice, steps should also be taken to prevent the deletion, destruction or overwriting of data in both electronic and hard-copy form. Often, the investigative team will work directly with the company's IT department to ensure that the relevant electronic data is preserved.

Understanding and protecting legal privileges – an important predicate

Two legal privileges must be understood by the audit committee to effectively structure and oversee an internal investigation – the attorney-client privilege and attorney work-product doctrine. The privileges will pervade the audit committee's decision-making process.

The attorney-client privilege applies only to communications between the attorney and the client in aid of providing legal advice. In this case, the client is the audit committee or the company itself. When counsel conducts interviews in order to render advice to its client, the content of those interviews may also be protected by either the attorney-client or work-product privilege, as long as counsel and the client follow certain procedures dictated by the case law establishing those privileges.

The attorney work-product doctrine protects counsel's mental impressions and legal analysis from facts learned by counsel. This privilege from disclosure covers attorney notes, such as those taken during the course of interview. It does not, however, extend to verbatim notes or tape recordings of interviews. Consequently, such methods should not normally be utilized during the course of witness interviews.

Most importantly, the audit committee should remain mindful that these privileges against disclosure protect only counsel's communications or mental impressions and do not protect the underlying facts or corporate records themselves, and that the privileges are not without exceptions.

"Legal privileges relating to communication with legal counsel do not provide blanket coverage and protect only certain communications."

In order to prevent waiver of these evidentiary protections, the audit committee and its counsel should ensure that their protected communications and work product are maintained in confidence and not disclosed to third parties. Care in dealing with notes of privileged communications and informal emails discussing such communications is particularly important.

Most important, disclosure to a third party will not be considered a waiver when made under a joint defense or common-interest agreement. These agreements are regularly used when the company and its officers have retained separate counsel and may be oral or in writing, depending upon the circumstances and relevant jurisdiction.

Waiver of the protections of these evidentiary privileges must be carefully considered in light of the potential for follow-on private litigation relating to the subject matter of the investigation. To the greatest extent possible, therefore, any decision about voluntary waiver of applicable evidentiary protections should be made at the conclusion of the investigation once all of the relevant facts have been uncovered, so that the company can take into account all the potential consequences of such a disclosure.

Deciding who should conduct the investigation

As a general rule, an attorney should conduct or, at a minimum, supervise the investigation on behalf of the audit committee so that the communications and work product generated during the investigation are protected by applicable evidentiary privileges.⁶

Moreover, audit committee investigations often require analysis of whether the law has been violated and the course of action that should be pursued to correct any violation and minimize potential liability for the company. This type of analysis is inherently legal in nature and is, therefore, best suited to experienced attorneys with the assistance

⁶ See, *Upjohn Co. v. United States*, 449 U.S. 383 (1981) (applying the attorney-client privilege to notes that attorneys prepared while conducting an internal investigation).

of relevant experts in accounting, finance, and other disciplines applicable to the specific inquiry.

On occasion, management may suggest that an investigation be handled by the internal audit team. The audit committee must be aware that such an investigation without legal oversight and direction is subject to no legal privilege against disclosure and can actually create evidence damning to the company's interests.

Determining whether to select in-house or outside counsel to conduct the investigation is a more nuanced question, as is determining whether to use the company's regular outside counsel or a firm with no substantial prior relationships with the company or its management.⁷

The use of in-house counsel provides some obvious advantages, because the investigators are more familiar with the company's operations and likely will be less expensive and disruptive to the company. Use of the company's regular outside counsel can present similar advantages.

The use of in-house counsel, however, also has significant disadvantages. In-house counsel is more likely to be (and be perceived as) less independent of company management. Circumstances can create conflicts of interest for in-house counsel, particularly where the allegations of wrongdoing implicate senior company management to whom the in-house lawyers report. Similar issues are present when using the company's regular outside counsel with strong ties to management and a perceived desire to receive a continuing flow of work.

On the other hand, outside counsel with no material ties to the company is likely to be more independent of management, and their analysis will be perceived as more objective by regulators or prosecutors.

Independent outside counsel will also likely have greater expertise and resources available than counsel who do not specialize in conducting internal investigations. Most important, experienced outside counsel may have already established credibility with the regulators or prosecutors from their conduct of prior investigations or through similar work experiences.

Use of outside counsel also increases the likelihood that the results of an internal investigation will be protected by the attorney-client privilege and work-product doctrine, discussed previously. Courts are far more likely to find that an internal investigation is protected if it is conducted by outside counsel. This is a critical factor when regulators are (or could potentially be) involved, or if there is a possibility of civil litigation (whether through shareholder actions or otherwise).⁸

The SEC's published policy statement discussing the factors it considers when providing leniency to companies (the Seaboard Report) encourages the use of an audit committee or special committee composed entirely of independent directors, assisted by counsel who had not previously represented the company.

Finally, it should be noted that use of outside counsel other than regular outside counsel is required by some audit firms in Section 10A investigations.

With these factors in mind, as a general rule, the use of independent outside counsel with no (or non-material) prior relationships with the company or its management is indicated when:

(1) the allegations under investigation involve serious misconduct or the conduct of senior officers; (2) the impact upon the company is potentially damaging; (3) the accuracy of the company's financial statements is implicated, particularly if a restatement is possible; (4) regulators or prosecutors may be asked to rely upon the investigation; (5) the investigation is triggered at the request of external auditors' action pursuant to

Section 10A; or (6) use of the company's in-house investigatory resources is otherwise inappropriate due to the nature of the matter being investigated.

Retention of forensic and other consultants

Investigations often go beyond legal issues and counsel almost invariably will require expert assistance in order to preserve, obtain and understand the evidence uncovered in an investigation. The attorney leading the investigation should retain any such expert directly to bring the expert's work within the umbrella protections of the attorney-client privilege.⁹

Most audit committee investigations involve some accounting or financial component. Accordingly, investigative counsel will commonly retain accountants to provide assistance during the course of the investigation. Forensic accountants are trained and certified in investigative skills, the collection and evaluation of evidence and the communication of findings to interested parties such as law enforcement, regulators or juries.

Counsel also often use forensic accountants and technology experts to identify and acquire digital evidence located on computers, smartphones and other electronically stored information (ESI) systems. Forensic technology specialists often assist the investigative team by performing forensic tasks such as recovering deleted files or cracking password-protected files, as well as providing a sound review platform to facilitate the review of electronic evidence.

Special considerations when dealing with whistleblowers

With the passage of Sarbanes-Oxley and the enactment of Dodd-Frank, US public companies now find themselves in a world in

⁷ Some very large companies facing the need for frequent internal investigations have established a separate in-house investigative function staffed with lawyers who do not directly interface with or report to line managers. In these situations, care is taken to ensure the independence of investigative staff members. The existence of such an investigative team can permit many internal investigations to be conducted using internal resources, although for cases involving serious or widespread misconduct, or conduct implicating senior management, prudence may still dictate the use of external resources.

⁸ See *In re Sealed Case*, 737 F.2d 94, 99 (D.C. Cir. 1984).

⁹ See *In re Grand Jury Proceedings*, 786 F.2d 3 (1st Cir. 1986); Jay M. Zitter, "Applicability of Attorney-Client Privilege to Communications Made in Presence of or Solely to or by Other Attorneys, Co-parties, and Their Staff," 64 ALR 6th 655 (2011).

which whistleblowers abound. Indeed, the SEC reported that it received more than 3,000 separate whistleblowing complaints relating to alleged financial improprieties in 2012 alone.¹⁰

When an investigation is instigated by whistleblowing activity, special care needs to be taken. While the company may seek to determine the identity of an anonymous whistleblower, those efforts must be in legitimate pursuit of an opportunity for follow-up or to protect the whistleblower from retaliatory conduct. Retaliation against a whistleblower is itself an illegal act, and can subject the company to substantial fines, as well as exposure in civil litigation. Similarly, intimidation of a witness is a violation of both federal and state law. Tact and discretion are essential to ensure that efforts to identify and follow up with the whistleblower do not backfire.

With this in mind, when a whistleblower is involved, in addition to the legal advice that the corporation seeks with respect to the conduct of the investigation, the audit committee should insist that the company's Human Resources department and qualified legal counsel familiar with labor and employment matters are at the table.

If the whistleblower has identified conduct that ultimately leads to a restatement of the corporation's financial statements, certain senior executives of the company may be required to disgorge all or a portion of their incentive compensation for those years subject to the restatement. This disclosure risk creates a potential conflict between the needs of the audit committee to ensure a thorough investigation and the pecuniary interests of the senior management team. The audit committee should be aware of this tension, and should take steps to assure that the investigation is conducted in a manner that does not allow management's financial interests to compromise the investigation's integrity.

Required public disclosures and their impact upon the company's legal interests

Unfortunately, an issuer's public reporting requirements are not suspended pending the results of an internal investigation. The company must continue to file required periodic reports, including a management discussion and analysis (MD&A) presentation and related risk factor disclosure. These public filings may require some discussion of the investigation and its underlying facts, as well as any known risks to the company and any potential financial impacts created thereby. In some circumstances, a known risk may result in the addition of a contingency footnote to the corporation's financial statements or even a reserve for expenses or legal exposure.

The audit committee should maintain frequent communication with those responsible for the corporation's public reports to ensure that all legal obligations are being met, while at the same time balancing the need for thoughtful management of shareholder lawsuits and other civil litigation risks.

Ongoing investigations can sometimes delay public filings because of their impact upon the willingness of the CEO or CFO to provide the required certifications in connection with the company's financial statements. When these officers are aware that an investigation is ongoing, they are often reluctant to certify to the accuracy of the financial statements or to the adequacy of the company's internal controls until the investigation is complete and they are comfortable with the findings.

For this or other reasons, the company may be forced to file a periodic report on a delayed basis, requiring a notice to the market and stock exchanges and the filing with the SEC of a Form 12b-25. In extreme cases, the existence of an internal investigation may require an issuer to formally publish a notice of non-reliance on its prior-period financial statements. Suspension of trading or temporary loss of the stock exchange listings can occur. Such

events often have a significant effect on the corporation's market trading activity and stock price. These risks can cloud the judgment of an executive who has a significant portion of his or her net worth invested in stock or stock options in the company, requiring vigilance by the audit committee to ensure that the investigation is not hindered and that the company's disclosure obligations are fulfilled.

Investigatory findings may suggest that company's prior earnings guidance or other information published to the market is incorrect. Thus, information learned in the course of an investigation may give rise to a legal duty to update and correct prior corporate disclosures.

All of these factors must be taken into consideration in designing the investigation, determining its scope and managing public communications at the outset of the investigation, as well as throughout. The audit committee will often find that it is called upon to direct important disclosure decisions with imperfect and incomplete information. In addition, during the conduct of an internal investigation, the investigators' understanding of the facts often evolves as additional evidence is uncovered. The company must therefore continually reassess its disclosure obligations, and the audit committee should consult its regular corporate disclosure counsel to decide the timing and nature of any public disclosures that are advisable as the facts unfold.

Although there are no hard and fast rules governing the timing for reporting either preliminary or final findings of an investigation, issuers must consider the nature and magnitude of the investigation and its impact on the financial statements. They should also consider any criminal and civil liabilities that may arise in making decisions regarding the need for reports to the board of directors, external auditors, or to the markets or regulators, either on an interim or final basis.

¹⁰ See Press Release at: www.sec.gov/news/press/2012/2012-219.htm. Note that government contractors also must deal with whistleblower claims under federal and state False Claims Act legislation, statutes that date back to the US Civil War.

Avoid the desire to minimize or provide comfort

At the outset of an internal investigation, there is a natural desire to provide comfort and assurance to the market and other constituencies that there has been no illegal conduct and that the matters in question will not result in significant adverse effects to the company. Making such statements before all the facts are known is problematic. Unfounded assurances can lead regulators or courts to believe that the company is not undertaking a serious and open-minded self-investigatory effort. Such statements can also result in the need for subsequent corrective disclosure as additional facts come to light. Finally, they can seriously damage the credibility of the company, its board of directors and management should subsequent findings prove otherwise.

Therefore, in most situations where an announcement is required, the best course of action is to simply announce that the matter is under investigation, the corporation is taking it seriously, the investigation will be independent, and "appropriate" cooperation with the government is taking place (when relevant).

In circumstances where the company's investigation is proceeding in tandem with a governmental inquiry, companies publicly state an intention to fully cooperate with the government. Prior to making such an announcement, the company should work with counsel to assess whether and to what extent it will, in fact, cooperate with the government. While cooperation is generally indicated, it is not appropriate in all circumstances. Making a public statement of an intention to cooperate with the government that ultimately is not accompanied by such cooperation is problematic, and can damage the company's credibility.



Managing communications with the company's various constituencies

There are numerous constituencies that must be considered during the course of an investigation, including the public market, institutional investors, regulators and prosecutors, and the company's own board of directors and management, as well as its external auditors, customers and employees. Balancing the demands and expectations of these various parties can be one of the more challenging aspects of overseeing an investigation.

If the investigation is triggered by a criminal complaint or subpoena from regulators or prosecutors, the investigation team must be prepared to respond to any deadlines set by the government and to manage the government's expectations and avoid further damage. In certain contexts, the mere receipt of investigatory demands can trigger public disclosure obligations. On the other hand, if the investigation is spurred by an internal complaint, the company generally will have more flexibility with respect to the timing of any public communications or disclosures.

The company's employees or customers may be unsettled by the announcement (or even the commencement) of an investigation, requiring thoughtful communication efforts intended to calm the waters without providing premature or false comfort. The use of experienced "crisis" public relations professionals can be helpful in crafting these communications.

"Although interest in the investigation may be keen, communications must be conducted on a careful and 'need to know' basis."

Even reports to the company's board of directors must be carefully managed, particularly if one or more members of the board of directors (such as the CEO) are implicated in the investigation.

Generally, the sharing of information regarding the investigation with the board of directors and management should be on a "need to know basis" in order to preserve the applicable evidentiary protections. The audit committee should be cognizant of the fact that any information provided to the board of directors may subsequently be subject to judicially compelled disclosure in subsequent legal proceedings. Courts have held that the attorney-client privilege does not apply to boardroom communications about investigatory findings in certain circumstances.

Normally, therefore, the best practice is to share information with the board of directors only after the investigation has been completed and the findings and recommendations have been adopted by the audit committee. (The form of the report to the audit committee is addressed in a subsequent section.)

Furthermore, curtailing the information shared with management is also important to prevent inadvertent disclosure to the public or to management personnel who may subsequently be found to be implicated in the alleged misconduct. Accordingly, limiting disclosures to management regarding the investigation, except for that necessary to further the investigation, is generally the best course of conduct.

Large institutional investors with significant stakes in the company may feel that they deserve a briefing regarding the investigation at its outset or as it proceeds. Disclosure of facts to some but not all investors is problematic and may violate SEC Regulation FD. While the desire to privately comfort large holders is understandable, it should be resisted.

Dealing with the company's external auditors during the investigation

The company's external auditors are a very important constituency that must be managed with transparency and integrity throughout the investigation. The auditors will be keenly interested in the timing, thoroughness and conclusions of the investigation, especially if it involves allegations of wrongdoing by those members of management who make representations to the auditors and/or required certifications in publicly filed financial statements.

External auditors will frequently engage their own forensic accountants and data specialists to assist the audit team in its assessment of the investigation. This forensic team will "shadow" the audit committee's investigation and advise the audit team whether it was conducted in a thorough, independent and effective manner in order to assist the auditors in determining whether the investigative findings are worthy of reliance.

It is usually helpful for the audit committee to communicate with the external auditors about the scope of the investigation and who will perform it at an early stage. While the auditors are not in a position to approve the company's choice of counsel or forensic accountants, early communication will provide the opportunity for the auditors to provide input and to flush out whether the auditor's perception of the competency or objectiveness of the audit committee's preliminary choice would make it less likely that the auditors will accept the findings of the investigation.

Likewise, it is often beneficial for the audit committee to communicate the initial scope of the investigation to the external audit team as soon as possible, especially if the issues being investigated were identified by the auditors subject to Section 10A. While the auditors may suggest revisions or expansions to the scope, the auditors will be quick to remind the company that the audit committee and the investigative team retain the ultimate responsibility to define the scope and timing of the investigation.

Furthermore, to the extent the scope of the investigation changes as new information is discovered, these changes should be timely communicated to the audit team. This type of ongoing communication can go far in building credibility for the investigation with the external auditors.

“Auditors are more likely to trust and accept the results of an investigation if they have been kept informed in a timely and transparent manner.”

The investigative team will often need to provide the external auditors with information about its work plan and progress in order to satisfy the audit firm's shadow investigation team. In some cases, it can be important to frequently discuss the progress of the investigation with both the audit and shadow investigation teams.

The auditors' shadow investigative team will often ask about the sources of electronic and hard-copy data that have been preserved, collected and reviewed. The auditor's shadow team will also likely be interested in the method in which electronic data is collected, processed and reviewed by the investigative team. The audit team will consider such information when assessing the completeness of the data relied upon by the investigative team, as well as the effectiveness of the review procedures performed.

The auditors will also likely inquire about the witnesses being interviewed, as well as when the interviews took place and who was present. With privilege concerns in mind, investigative teams normally convey such information to the audit firm through an oral debriefing, in which members of the investigative team, normally counsel, will summarize key portions of the interviews rather than providing copies of interview notes. Depending on the situation, the audit firm might be interested in the questions

asked, as well as the specific answers provided by the witness.

Auditors are often interested in the interviewer's impressions of key witnesses. For example, the interviewer's impressions of the witnesses' body language or whether they felt the witness was being truthful are sometimes discussed during the interview debriefs. Depending on the results, the auditors might make suggestions regarding additional questions or additional interviews. As previously mentioned, while the auditors may make suggestions, they will advise that the scope and work plan are the responsibility of the audit committee and the investigative team.

Conducting the investigation

Once the scope has been determined and the work plan is established, the process of conducting the investigation can be divided into three general phases: (1) gathering documentary evidence; (2) analyzing documentary evidence; and (3) conducting witness interviews.

As a general matter, document review and analysis and witness interviews will inform and assist one another. The process of speaking with witnesses often leads to the discovery of new documents, and discussing a relevant document with a witness during an interview frequently serves to help the witness recollect the facts and provide the basis for a more detailed and productive interview.

Accordingly, whether to conduct interviews first or review all of the documents before beginning interviews is always a strategic consideration, and the right answer will depend on the facts and circumstances.

Sometimes this tension will be resolved by conducting preliminary interviews to help the investigators gain a better understanding of the scope of the issues and to help to shape the investigatory work plan.

Document review

The document review process is a critical step in the investigation and often the most time consuming. For these reasons, the investigators should quickly attempt to gain an understanding of the size and scope of the relevant documentary evidence they must scrutinize during the investigation. Relevant sources of documentary evidence may be both internal to the company and external, and may include documents from vendors, business partners and government and non-governmental regulators. Investigators most likely will encounter a mixture of ESI (such as employee email accounts, text messaging, server-connected back-up data, metadata) and paper records, such as calendars and company files.

As the document review process proceeds, the investigators will attempt to create a timeline of key events to better understand how the issue developed chronologically. This will help the investigators gain further insight and also help to explain the results of the investigation to its various constituencies.

Data analysis

Once the relevant documents have been assembled, the investigative team will generally analyze the data using a variety of forensic tools. Automated review tools allow the investigative team to review a large volume of data in a relatively short time without changing the information within the files or in the accompanying metadata. Thousands, or even millions, of pages of documents are often reviewed during an investigation, and using proper review tools and a well-controlled environment can help to ensure that the review is more efficient, thereby controlling the cost of the investigation.

“The use of modern forensic techniques can speed and enhance an investigation.”



Forensic accountants can also run specialized data analytics against the financial data (structured data) and/or unstructured data such as email to uncover trends, patterns or “red flags” that can indicate areas of suspicious activity. Data analytics can quickly and efficiently point the investigative team to relevant data, thereby limiting the population of information to be reviewed and analyzed by the investigators. Whether the allegations relate to bribery and corruption, earnings management or asset misappropriation, the combination of structured and unstructured data will typically contain signs of any misdeed. Review procedures can also be customized to generate a more robust and complete picture for the investigation team, while controlling costs and allowing the investigation to be concluded more promptly.

By way of example, large charitable or social contributions in certain foreign locations can suggest bribery and corruption issues, while journal entries with large rounded currency amounts are a possible indication of earnings management. Large unspecified marketing expenses or unusually high commissions to sales agents can also be indicative of bribery activity. Given the availability of computer applications that facilitate the ready creation or alteration of documents, investigators will be on alert for documents of uncertain origin.

Interviewing witnesses

While each investigation is different, as a general matter it is often best to conduct interviews of lower-level employees and less important witnesses first to gain an understanding of the background and context for the allegations at issue, to be followed by interviews of the key or apex witnesses once a more clear understanding of the issues is achieved.

The interviews themselves should be conducted by an attorney with at least one other person present as a witness and note taker. Often, the forensic accountants assist with the interviews. The attorney investigator should take the lead asking questions and utilize the relevant documents obtained during the document review to question the witness regarding the facts at issue.

The attorneys conducting the interviews will give specialized warnings to the witnesses to make clear that the attorneys do not represent the witness and that the witnesses’ statements can, under certain circumstances, be made public. These warnings sometimes occasion delays, as witnesses seek their own legal counsel. (See section below discussing separate legal counsel.)

Special considerations in multi-country investigations

Significant complexity is introduced when the investigation touches multiple countries.

Each country has its own data privacy, data collection and data transfer limitations. It is important that the investigative team, overseen by the audit committee, has an understanding of these limitations and that any professional adheres to the investigative team’s decisions interpreting these limitations.

Generally, these local regulations control the transfer of an employee’s personal information, company trade secrets, or, for companies doing business with state-owned entities, the transfer of government secrets. For example, the Law of the People’s Republic of China on Guarding State Secrets includes broad provisions restricting the export of electronic data and contains an incredibly expansive definition of “trade secrets.”

Thus, in some foreign jurisdictions, before the data can be exported, it must be reviewed and cleared of legally protected information to prevent transfers from being considered a violation of the state secrets or other laws, resulting in significant sanctions (including fines and incarceration) for the company and its outside counsel.

These data protection laws are commonly both broad and vague, requiring the retention of local counsel to assist investigative counsel in its interpretation.

Apart from legal considerations, engaging a qualified eDiscovery or forensic consultant in some foreign jurisdictions can be challenging. If the lead consultant does not have a wide

global footprint, investigators can be forced to engage multiple vendors, resulting in differing processes and results that must be harmonized. The simple process of collecting data from antiquated legacy systems can be difficult, and interfacing with the company’s local accounting staff may require the use of interpreters.

“Investigations conducted in foreign countries can be challenging.”

In addition to the legal restrictions governing international data collection, practical logistical issues must be considered. The physical security of the collection team should be evaluated, particularly in totalitarian or developing countries. Retention of private security can significantly increase the costs of the project. In developing countries, unexpected events such as the failure or interruption of electrical or other utilities can disrupt the continuity of the work, causing overall project delays.

Cultural factors must also be considered. In certain countries (notably China, Japan and Germany), investigators should not expect that employees will voluntarily implicate a fellow employee in misconduct. And, in some countries, what would be regarded in the United States as gross misconduct is instead viewed as the ordinary conduct of business.

Many business cultures simply have no analog for self-investigatory activity, and educating employees regarding their need for cooperation can be challenging.

In some countries, employee interviews can take place only in the presence of an employee union representative or with the approval of relevant unions or work councils. These factors can cause delay and can complicate confidentiality and privilege considerations.

Finally, of course, linguistic barriers can be significant. Conducting interviews through interpreters is tedious, time-consuming, often ineffective and always very expensive.

In summary, the audit committee must understand that a variety of local matters can complicate an investigation and make it dramatically more expensive. In extreme cases, they can make a complete and thorough investigation practically impossible.

Protecting personal privacy interests and data protection laws and regulations

Data privacy is an extremely complex legal topic and it is strongly recommended that appropriate advice is obtained before collecting or transferring data that may contain an employee's personal data. During data collection outside of the United States, the engaged e-Discovery vendor or local legal counsel should work with investigatory counsel to understand applicable collection restrictions and when employee consent is required.

Data sources identified for production to a third party should be evaluated for Personally Identifiable Information (PII). When producing these data sources, where possible, the data elements containing the PII should be truncated or redacted and transferred in an encrypted format.

Once it is determined that data can lawfully be collected, it may need to leave the confines of the company's network and be transferred to a third party for processing or analysis. The company must be aware of and accept the transfer protocols established by the third party and address issues such as encryption. The investigator must also understand how its data will be physically stored by the vendor. Preferably, it would be stored in a camera-monitored evidence room with biometric entry and interior safe use to store sensitive data. Additionally, the investigator must understand how data is stored electronically by the vendor to ensure that the data will not be intermingled with data belonging to the vendor's other clients.

The need for separate legal counsel for employees, managers and board members

The circumstances of an investigation may reveal that the legal interests of the company and one or more of its individual officers or employees, or one or more members of the board of directors (or the board as a whole), are divergent. In such cases, the retention of separate legal counsel for one or more of these persons or entities may be advisable, or even required.

The introduction of multiple attorneys representing different clients with differing legal interests can greatly complicate any situation, and most assuredly make any effort to complete a thorough and timely investigation more difficult and expensive. Accordingly, the audit committee should work closely with its counsel to manage these matters.

The company may be faced with demands for indemnification of legal fees and expenses from those retaining separate counsel. Decisions as to such payment require consideration of a labyrinth of legal and practical issues as to which the audit committee and the company will wish to seek counsel. In short, the decision to accept the responsibility for payment of separate counsel is not an automatic one and should be made with care.

Often, counsel leading an investigation will suggest that the retention of counsel by other related parties be thoughtfully coordinated, particularly if the company is being asked to underwrite the cost. In doing so, lead investigatory counsel is generally seeking to avoid the participation of counsel who, while perhaps well-meaning, lack experience in the complexities of governmental or internal investigations. Efforts are also generally made to avoid retention of counsel known for recalcitrance or other conduct that may complicate or compromise an investigation or otherwise damage the legal interests of the parties.

Analysis of internal controls

Internal controls have long been a key element of business entity operations. The need for enhanced controls followed the enactment of the FCPA of 1977 and then again after the adoption of Section 404 of Sarbanes-Oxley.

Internal controls include processes and practices that protect the integrity of financial reporting information, and safeguard against financial manipulation and misstatement through the use of detective and preventative measures that operate within an organization. An effective internal control framework is typically complex, and is composed of written policies and procedures that target specific areas of risk within an organization. Effective internal controls require collaboration among the board of directors, the audit committee, internal and external auditors, risk management personnel, investigators, operations personnel and others.

While effective operating controls within an organization can curtail the misbehavior, no internal control is immune from failure. Internal controls typically fail either as a result of a significant design or implementation deficiency or through intentional circumvention.

Conversely, internal controls that are materially weak or are not monitored for operating effectiveness can also expose a company to fraudulent activities. Typically, organizations that implement a formal internal control framework routinely monitor their controls to ensure they are operating effectively. When controls are not routinely assessed for operating effectiveness (or are not modified to grow with the organization's size and complexity), failure is more likely. Such deficiencies are often among the primary focuses in an investigation.

There is no easy way for an organization to defend against intentional circumvention of controls, especially when collusion occurs among employees or persons outside of the organization. Many of the greatest fraud cases in history involved extensive collusion.

The ACFE's Report to the Nations showed that collusion, over time, has been reported in 36% to 42% of all fraud cases.¹¹ The effects of collusion in fraud cases approximately doubles the median loss compared with frauds involving a single person.

During an investigation, the company's internal controls are heavily scrutinized as a potential root cause of any misconduct. Depending on the allegations being investigated, forensic accountants will obtain an understanding of the internal control environment to determine possible vulnerabilities and whether stronger or different controls would have prevented the alleged wrongdoing.

Frequently, the documentation of the control environment will be studied to understand what policies and controls are in place. Then, the investigative team might review Sarbanes-Oxley 404 work papers to ascertain the historic effectiveness of the controls. This data can help the investigative team to determine whether controls are effective or have likely been circumvented or are simply weak. Such information can also provide the investigative team with the identities of company personnel who might possess relevant electronic or hard-copy data or be appropriate subjects for an interview.

At the conclusion of an investigation, the audit committee, in consultation with the company's internal and external auditors, may determine that an enhancement of the company's internal controls is necessary in order to help prevent future misconduct. Such enhancements are a frequently recommended remedial measure in outside counsel's report to the audit committee and can assist in satisfying regulators that the company is committed to future compliance. Certainly, the company's external auditors will also be interested in any remediation steps that are performed to bolster the internal control environment.

Concluding the investigation and dealing with regulators

Reporting to the audit committee

At the conclusion of the investigation, counsel (with assistance from their expert consultants) will present a report to the audit committee. The report may be verbal or written, depending on the need to disclose the report to third parties and the implications in doing so may have for the investigation as a whole. Whether the report is verbal or written, it should: (1) include an identification of the allegations or facts and circumstances that gave rise to the investigation; (2) respond to the issues that gave rise to the investigation, i.e., the scope of the investigation, length of the review and investigative steps taken; (3) recite findings of fact regarding the issues of the investigation, with reference to the evidence uncovered; (4) detail legal analysis of the facts to the relevant laws at issue; and (5) make recommendations for remedial action to address the issues investigated, such as disciplinary action against wrongdoers, and identification of corrective steps already taken to do the same.

The level of detail for the final investigation report depends upon the audience and the issues, as will the level of detail in the audit committee meeting minutes.

Reporting to the company's auditors

The company's external auditors are an important audience for the results of any investigation that implicates either the company's financial results or the integrity of its management team. In dealing with the auditors, candor and transparency will be key considerations, as will the timing of the communications to ensure that the auditor has ample opportunity to assess the investigation's findings, thereby avoiding delays in financial reporting.

By including the audit team early in the process and keeping them up to date on the investigation's progress, the auditors will be able to evaluate the integrity of its process and reliability of its findings on an ongoing basis. Frequent and timely communication

will also allow the auditors to plan for any additional procedures they may need to perform to complete the audit, including bringing in their own forensic accountants, or shadow investigation team, to evaluate the work and findings of the company's investigation team.

In many cases, the auditors' shadow investigation team will review the investigators' work and make its own assessment of whether it was thorough and complete. If the audit team is included early in the process they, along with their shadow investigation team, will be able to work concurrently with the investigation team and make suggestions for enhanced procedures, thereby avoiding delays in "sign off" by the auditors once the investigation is complete.

When reporting the results of an investigation to the company's auditors, legal counsel will be keenly concerned about protecting any attorney-client or work-product privileges that may attach to the results of the investigation or its workpapers. There is a pronounced tension between the lawyer's desire to protect those privileges, and the auditors' need to know that a thorough and meaningful investigation was conducted, and that any impact on the company's financial statements has been appropriately reflected.

Experienced legal counsel have developed practical approaches to deal with this challenge. While it is often not possible to provide the auditors with copies of the same written materials provided to the audit committee or the board of directors without placing privileges at risk, oral briefings, the use of source documents that are not privileged and other measures can serve the goal of providing the appropriate information to the auditors, while protecting the company's legal privileges. The audit committee should review with its investigatory counsel the steps that will be taken to meet these competing goals.

These concerns about protection of the privilege are not always present. In certain very high-profile or other matters, the corporation and its legal counsel may have already determined that a public report of

¹¹ ACFE Report to the Nations on Occupational Fraud and Abuse, 2012 Global Fraud Survey, pg.43.



the investigatory findings is required. In these cases, the auditors can be provided with the same information being generally publicized without separate concerns about attorney-client privilege or the work-product doctrine.

Dealing with regulators

At the conclusion of the investigation, the company (i.e., the board of directors) will need to decide whether, how and when to disclose the findings of the investigation to regulators or other third parties. The company should be cognizant that such disclosure may be deemed a waiver of any evidentiary protections previously enjoyed during the course of the investigation. The resulting waiver may permit other third parties, such as plaintiff's litigation counsel, to compel production of whatever information, if any, is disclosed to regulators. Even partial disclosure to regulators can provide a legal basis to compel disclosure of additional evidence that is related to the disclosed information.

Regulators asked to rely upon the results of an investigation sometimes explicitly request that the company waive the attorney-client privilege and work-product protections in order to facilitate full disclosure. Such waivers are characterized as a precursor to obtaining "credit" from the regulators for "full" cooperation.

The audit committee should be aware that disclosing privileged information may not actually be necessary to obtain credit for cooperation from the DOJ or SEC. Neither the SEC Enforcement Manual nor the US Attorneys Manual requires that a party waive its attorney-client privilege or work-product protections in order to receive cooperation credit. Rather, as experienced counsel will assert, the proper question is whether the company has timely disclosed all relevant facts concerning the alleged misconduct.

If a criminal violation has been uncovered by the investigation that requires mandatory disclosure to the government, the company must prepare to disclose the requisite information to the appropriate regulators. Different regulators require different methods of mandatory disclosure. For

instance, if mandatory disclosure is required because the investigation results conclude that a violation of law has occurred that is material to the company's financial statements, then a Form 8-K disclosing the violation must be filed with the SEC.

A more difficult question for a company is often presented where a violation does not require disclosure. In such instances, the company should weigh the benefits of self-disclosure to regulators with the risk of discovery by regulators through other means, leading to more stringent regulatory action.

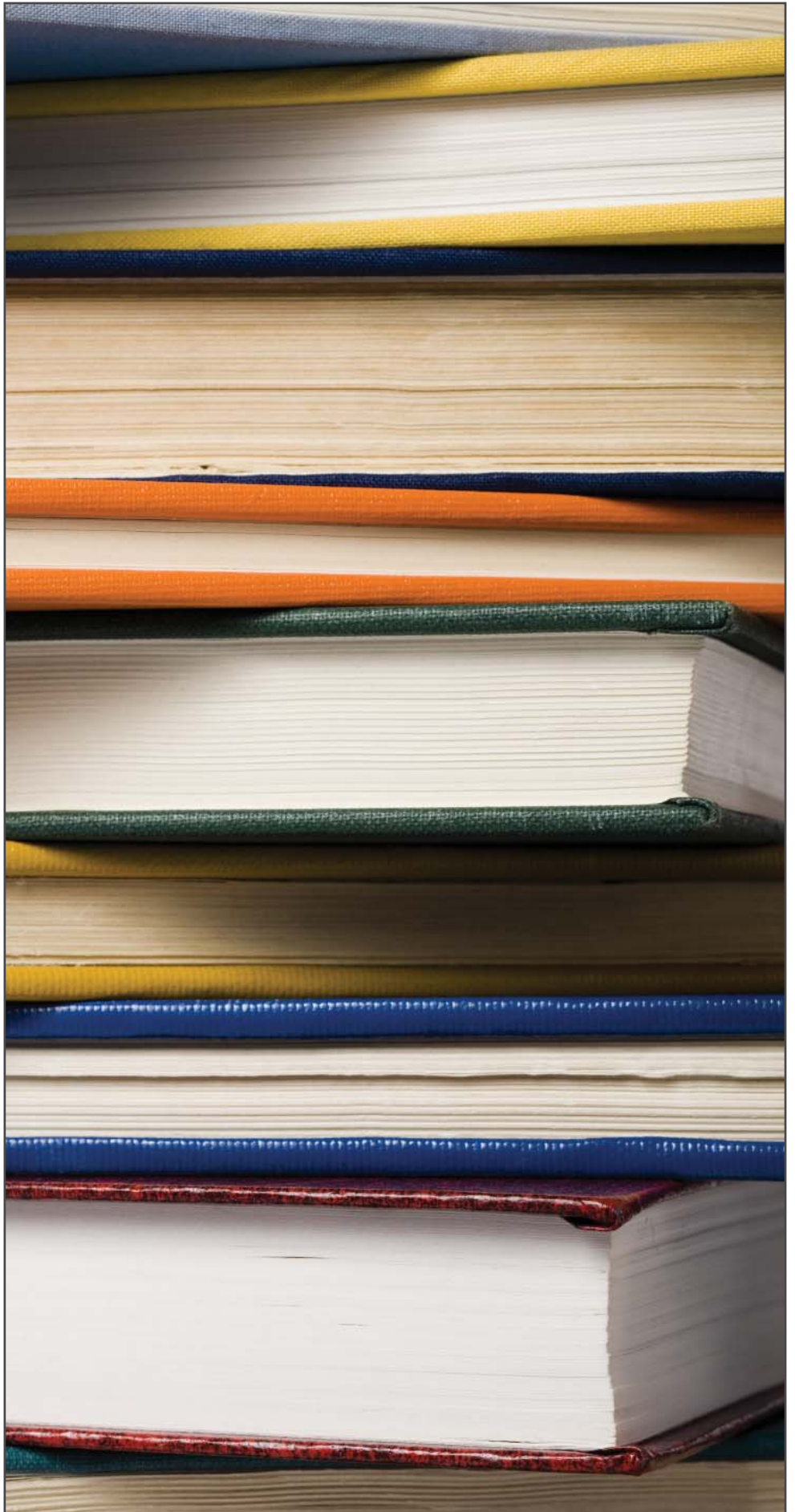
Self-reporting can result in leniency for the company. Many government agencies have announced policies stating that companies who voluntarily disclose infractions will receive some measurable benefit. The most notable of these programs is maintained by the DOJ which, under the Federal Sentencing Guidelines for Organizations (the Guidelines), specifies that a corporation that "fully cooperates in the investigation" and demonstrates "acceptance of responsibility for its criminal conduct" receive a two-point reduction in the Guidelines range for cooperation credit.¹² This cooperation credit may measurably reduce the company's punishment under the Guidelines, including applicable fines and forfeitures.

Conversely, electing not to self-disclose discovered criminal violations may result in increased fines and may also lead to the inference that the violations were improperly covered up, even when mandatory disclosure was not legally required. This may also lead to unwanted adverse publicity that could adversely affect the company. Thus, decisions about voluntary disclosures are among the most difficult that a company will be required to make. Accordingly, in any dealings with regulators, whether through voluntary or involuntary disclosure, it is critical to engage experienced outside counsel with established credibility with the regulators or prosecutors to inform those decisions.

¹² U.S.S.G. § 8C2.5

Conclusion

Overseeing an audit committee investigation is complex, intense and time-consuming. Making the right choices at the outset and along the way is critical to obtaining a good outcome and to ensure that the audit committee properly discharges its legal and fiduciary duties.



Authors

Frank M. Placenti

Partner, Squire Sanders
Phoenix, Arizona
+1 602 528 4004
frank.placenti@squiresanders.com

Gabriel Colwell

Of Counsel, Squire Sanders
Los Angeles, CA; Washington, DC
+1 213 689 5126, +1 202 626 6726
gabriel.colwell@squiresanders.com

Joseph Walker

Partner, Squire Sanders
Washington, DC
+1 202 626 6725
joseph.walker@squiresanders.com

Jeff Ferguson

Partner, Ernst & Young LLP
Dallas, Texas
+1 214 969 8994
jeff.ferguson@ey.com

About Squire Sanders

Squire Sanders is one of the strongest and most geographically diverse legal practices in the world, with offices across the Americas, Asia and Europe.

Squire Sanders refers to the global organization and includes member firms Squire Sanders (US) LLP, Squire Sanders (AU) GP and Squire Sanders (UK) LLP.

Squire Sanders has active Corporate Governance, White Collar, Investigations and Compliance Practices including hundreds of professionals throughout the world with experience in a variety of industry sectors and with governmental and regulatory agencies in most countries.

EY | Assurance | Tax | Transactions | Advisory

About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

About EY's Fraud Investigation & Dispute Services

Dealing with complex issues of fraud, regulatory compliance and business disputes can detract from efforts to succeed. Better management of fraud risk and compliance exposure is a critical business priority – no matter the industry sector. With our more than 2,000 fraud investigation and dispute professionals around the world, we assemble the right multidisciplinary and culturally aligned team to work with you and your legal advisors. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide.

© 2013 Ernst & Young LLP and Squire Sanders (US) LLP.
All Rights Reserved.

SCORE No. WW0303
1307-1107524 NY

ED none

This publication contains information in summary form and is intended for general guidance only. It is not intended to be a substitute for detailed research, the exercise of professional judgment or as legal advice applicable to any particular circumstances. Neither Ernst & Young LLP, Squire Sanders (US) LLP nor any member of either organization can accept responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor and/or legal counsel. Certain material herein might be regarded as advertising or marketing materials under the ethical rules of certain jurisdictions in which lawyers within Squire Sanders are licensed to practice law.