



Governance Insights Center

ACES (Audit Committee Excellence Series)



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Overseeing internal investigations

Internal investigations can be a reality for many companies, so audit committees need to be prepared.

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Whistleblower tips and complaints are on the rise—and some lead to internal investigations. Investigations can be lengthy, stressful and costly. Audit committees often play a critical role overseeing investigations from start to finish. Are you prepared?

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What is the audit committee’s role?

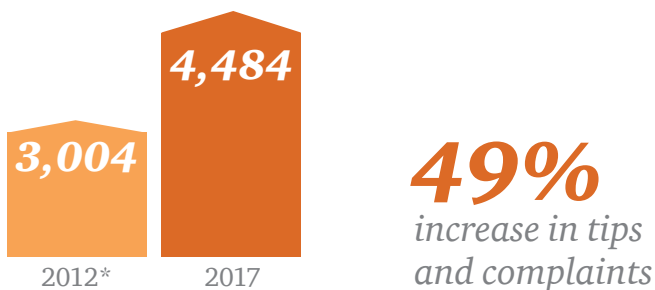
Companies are getting more whistleblower tips and complaints. Shareholders, employees and regulators expect companies to follow up, and resolve any issues. With the higher volume of tips and complaints, for many companies it is not a matter of *if* a significant complaint will occur—but *when*.

Complaints often involve a possible economic loss to the company and have accounting, internal control and disclosure ramifications. As a result, the audit committee is usually called upon to oversee or direct internal investigations.

What type of claims trigger an investigation?

Investigations can be triggered by a variety of complaints. They range from allegations of financial reporting fraud, bribery and conflicts of interest to harassment and cyber theft. Some of these activities could violate company policy, while others could also violate laws, such as the Foreign Corrupt Practices Act (FCPA).

Dodd-Frank’s whistleblower program activity



* First full year of whistleblower program

Source: US Securities and Exchange Commission, *2017 Annual Report to Congress: Whistleblower Program*, November 2017.





To investigate or not?

Companies receive all kinds of complaints from internal hotlines or other sources. Some stem from harmless squabbles between employees. Others might involve illegal acts that could have a material economic and reputational impact on the company. Some may have already hit the media, possibly creating a crisis situation. All complaints require some level of follow up by management. But deciding which require a more extensive investigation is a judgment call. This decision is a key management compliance function—which typically requires the oversight of the audit committee.



*(e.g., SEC, foreign regulators)

Audit committee members should ask: how do we know if management’s follow-up is sufficient, and what level of detail should we receive from management? The answer often depends on the volume of complaints and the company’s risk assessment. For example, even a low-level complaint may be of interest to the audit committee if it relates to a highly-sensitive geography or business unit or if it is an indicator of a trend or theme. A best practice is for management to provide the audit committee with certain details of complaints at each meeting, such as the nature of the complaint, preliminary risk assessment, and the business unit(s) and geographic location(s) possibly impacted. This allows the committee to evaluate the appropriateness of management’s response. If the complaint volume is high due to the size of the company, it may be more practical for management to provide a quarterly summary of complaints, with a periodic deeper dive into the details.

It is important to have an established escalation protocol for significant complaints. For example, matters that could impact the company’s financial reporting, the integrity of management, the external audit or could have potential media impact should be brought to the attention of the audit committee chair right away. This allows the chair to weigh in on urgent decisions of whether and how to investigate.



Do the allegations require an increased level of oversight by the audit committee? Consider the following factors:

- **Quantitative materiality** – possibly material to financial statements and/or could rise to a material weakness in internal controls
- **Qualitative materiality** – poses possible damage to brand or reputation
- **Severity** – involves a possible violation of laws or regulations
- **Potential reach** – allegations could involve senior management or a pervasive culture issue
- **Management’s response to a complaint** – an insufficient response or lack of objectivity or transparency
- **Difficult to resolve** – matter is past management’s originally planned resolution date

When a company doesn’t effectively investigate an allegation, it can lead to other problematic issues—such as negative press, damage to the company’s brand, increased litigation risk or more attention from regulators, such as the SEC. Proxy advisory firms have also recommended against voting for directors who failed to undertake credible investigations, adding to the pressure.

“*I fully intend to continue deploying significant resources to root out fraud and shady practices in the markets, particularly in areas where Main Street investors are most exposed.*”

– Jay Clayton, SEC Chair, July 2017





You have decided to investigate...now what?

If a complaint warrants escalated involvement by the audit committee, there are a number of crucial—and, at times, difficult—decisions that need to be made.

The more significant the allegation, the more involved the audit committee should be in overseeing or leading the investigation and determining the appropriate resources.

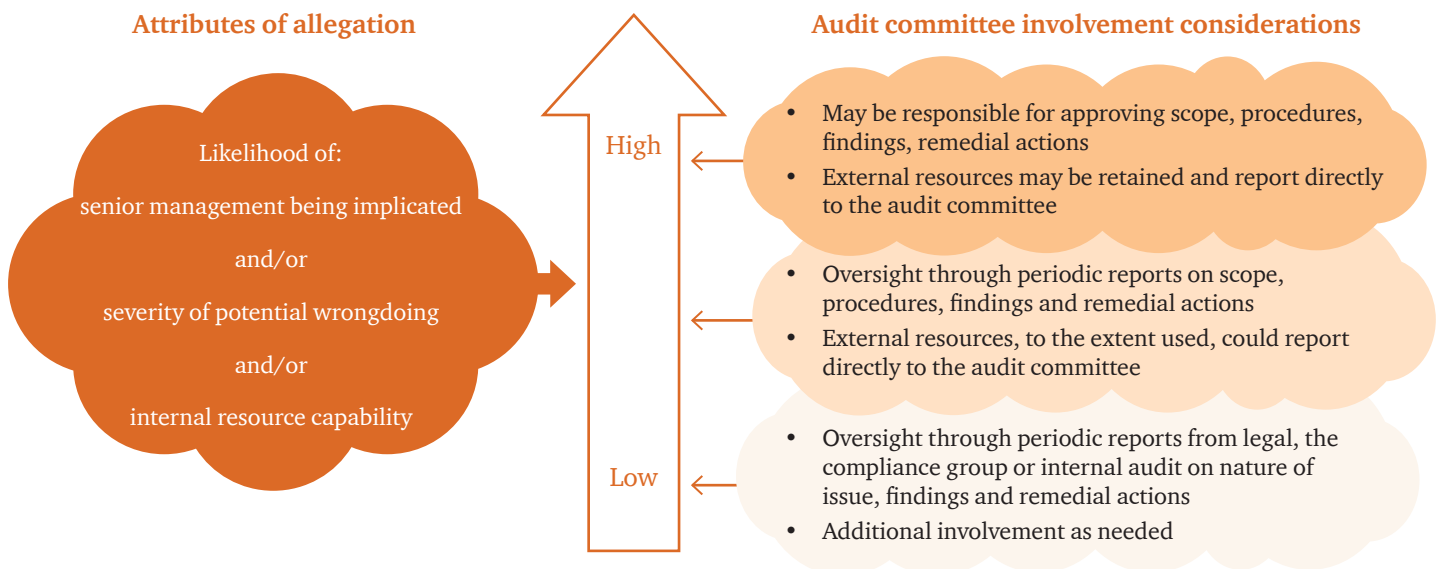
Any investigation needs to be conducted by an objective party. The underlying facts of the allegation will impact who that would be. For example, if the claim casts suspicions on upper management, then the investigation should be led by the audit committee or a special committee of the board.

Getting it right matters. A well-planned and well-executed investigation enables an effective and efficient response to potential subsequent regulatory or other inquiries.

Do we need an independent special committee?

In some cases, independent director oversight is called for. This includes allegations that could pose significant economic loss or reputational harm to the company, or when its executive management could be involved. In the latter case, the investigation is usually overseen or possibly directed by the audit committee. It's a natural fit given the requirement that this committee's members be independent, as well as their financial reporting oversight and fraud deterrence responsibilities such as oversight of the whistleblower hotline. If one or more members of the audit committee are conflicted, it is common practice to form a special committee of independent directors. In some cases, an independent director with specialized skills (e.g., cyber experience in a cyber fraud allegation) could be asked to join a special committee.

Extent of audit committee involvement





Installing a board committee as the leader of an investigation can be a difficult decision. This is especially true when the allegations involve executive management. This can be a sensitive decision that can strain the board’s relationship with management. By design, management will no longer have full visibility to the scope and execution of the investigation—or be able to manage the costs being incurred by outside resources, such as external counsel.

This is an important time to ensure you have the right chair for the independent committee. Experience, healthy skepticism, integrity, strong communication skills and bandwidth are critical. Investigations can involve challenging decisions and important communications to stakeholders under severe time pressure.

How do we select the investigation team?

What should you look for in an investigation team? Objectivity, subject-matter expertise and bandwidth. The severity of the allegations and the underlying facts drive the decision about who should lead the investigation. They will also dictate if external resources will be necessary.

Depending on the sophistication of the company and the capabilities of their internal resources, including the ability to conduct the investigation under the attorney-client privilege, the investigation of less significant allegations can sometimes be handled by in-

house legal, compliance and internal audit teams. With their institutional knowledge, these internal teams can save time and money. If the matter involves someone from management or requires a particular expertise or foreign language skills that exceed the internal team’s capabilities, they can consider bringing in outside resources.

For more significant allegations, the committee will want to call on external resources. They will bring the objectivity and experience that regulators and external auditors need to see. The critical decision is to engage the right external legal counsel to lead the investigation team. They, in turn, may engage others to assist them, such as forensic accountants.

When it comes to external legal counsel, the company’s regular law firm may not be the right choice. They already have a relationship with management, which could impair their ability to be objective. But objectivity is not the only factor. The outside counsel should also have experience in conducting similar investigations to minimize inefficiencies—or worse, the need for a redo.

“*Being part of an internal investigation was the most challenging experience of my board service.*”

– Board member



Preparing for the worst: be ready before an investigation arises

Companies and their boards should expect pressure to complete significant investigations quickly. Here's how to make the investigation more efficient, avert missteps and execute a thoughtful investigative process.

Line up the right outside advisors

Consider identifying and retaining objective external legal counsel in advance of a significant issue arising. Also consider on-call agreements with forensic accountants or e-discovery providers.

Establish communication protocols

When significant trouble confronts a company, it is important to manage communications with key stakeholders—shareholders, employees, external auditors, vendors, lenders and regulators. Companies should establish internal communication protocols, including who will be the company spokesperson and the form of communication (e.g., press release, social media). Also consider identifying a public relations firm in advance of a crisis.

Perform table-top exercises

Simulation crisis exercises are one tool companies use to prepare to respond to an allegation of wrongdoing. They can also help senior executives and directors understand their roles and responsibilities.

Establishing scope and procedures—how much is enough?

After establishing the right oversight committee and investigation team, the next task is to define the scope of the investigation. For example, should you limit the scope of the investigation to the one business unit cited in the allegation, or do you immediately expand the scope after considering the risk that the issue is more pervasive—maybe even company-wide? Getting the scope right upfront will help avoid unnecessary delays and costs down the road.

For significant investigations, the committee may feel considerable pressure from stakeholders to complete the process on a very short timeline. But determining the scope of the investigation and the nature of investigation procedures is key and needs to be a priority. These conclusions should not be compromised by deadlines.

Common causes of delays in investigations: areas to be managed



Initial scope too narrow or too broad



Insufficient company resources to obtain documents and accounting records



Failure to retain experienced external investigations counsel



Need for complex forensic accounting effort



Late decision by investigation team to communicate findings orally rather than a written report requiring management and external auditors to create documentation



Committee members should push back on the scope and/or procedures recommended by external legal counsel if they believe they are inadequate—or too broad. Be mindful that investigations can take unexpected turns along the way as additional findings come to light and the scope should be adjusted accordingly. There have been numerous situations when a company announced the results of an investigation only to realize that the issue was more pervasive than originally thought. This could compound the reputational impact on a company.

Typical investigation procedures



Identification and review of documents



Electronic search of digital information (e.g., emails)



Interviews



Review and analysis of books and records

How does the committee stay informed?

Throughout the investigation, regular updates to the audit committee by the investigation team are essential. The committee should continue to weigh in—and push back, if needed—on the planned scope and procedures of the investigation, as well as whether it should be expanded or reduced based on findings to date. And be prepared. The number of committee meetings and updates with the investigation team and full board could be extensive.

An investigation can also take a significant amount of management’s time. Management can easily lose the balance between the investigation and keeping the business on track. The audit committee and members of the investigation team should check in with management periodically to evaluate the need to add additional resources or make other corrections depending on the level of disruption.

It is important for the audit committee and investigation team not to discuss details of the investigation’s scope, procedures or findings with any potential witnesses, including members of management. However, members of management will need periodic status updates on certain aspects, such as estimated investigation timing, employee resource expectations and impact on financial reporting, so that so they can plan and perform their job duties effectively.

Does the company need to self-report to regulators, disclose the allegations or delay its SEC filings?

Regulators, such as the SEC, may expect or encourage the company to self-report when there are significant allegations. The regulators may want the company to communicate its investigation plan and provide periodic status updates. But the decision to self-report to regulators is complex. The SEC Enforcement Division’s Cooperation Program provides benefits to companies that cooperate, ranging from reduced charges and sanctions in enforcement actions to no enforcement actions at all. A related question is whether the existence of the investigation needs to be disclosed in an SEC filing, and if so, when. The advice of legal counsel is critical for both of these questions.



If the allegations could be material to the company's financial reporting (qualitatively or quantitatively), the company may need to delay its SEC filings until the investigation can be completed. Delays can trigger declines in stock price, violations of loan covenants and restricted access to the capital markets. These unwelcome consequences underscore the importance of timely communication. At the same time, disclosing deficient or erroneous information that needs to be updated or corrected can undermine credibility and lead to consequences with regulators.

How do we involve the external auditors?

Directors may be wary of involving the external auditors before they have evidence of wrongdoing. But it is important to understand that auditors have professional responsibilities under the auditing standards, international professional ethics standards and Section 10A of the Securities Exchange Act of 1934. The audit team may need to perform substantial work and involve forensic specialists if the allegations relate to fraudulent financial reporting or the integrity of senior management (even if not related to financial reporting), or if the claim could result in material penalties or fines.





Involving external auditors at the outset of the investigation and being transparent about the allegations and the company's planned response is a leading practice. Seeking their input early also helps avoid unnecessary costs and delays if they believe the initial scope and procedures are too narrow or inadequate and revisions are required.

The investigation is completed—what should we document and communicate?

Once the investigation is complete or nearly complete, the next step is documenting and communicating the findings. Some investigation teams or committees prepare detailed written reports. Others document their work in bullet point format in a slide deck. Still others communicate their findings to stakeholders orally rather than in a written report.

There is no one right answer. But it is critical that the parties decide on an approach as early in the process as possible. If decided late, it could cause delays in completing the investigation because management would need to create its own documentation to support its accounting and internal control conclusions and the external auditors would need to perform the appropriate procedures and create related audit documentation.

Consulting with legal counsel cannot be stressed enough. However documented, the investigation findings will be scrutinized and ultimately used by stakeholders, including management, external auditors and likely regulators.

In weighing the pros and cons of different reporting formats, consider the following:

- Findings and any remediation plan should be thoughtfully crafted, as they may form the basis of future public disclosures, if any.
- The board and audit committee will need to demonstrate that they fulfilled their fiduciary duties.
- Management will need documentation of the investigation's procedures and findings to substantiate their assessment of the impact on financial reporting and internal controls.
- Regulators, external auditors or others will likely request access to a written report. If a single privileged report is used and the external auditor requires access, while protection over work product would be protected, particularly as it relates to the external auditors, the attorney-client privilege may be waived. If written privileged communications are thought to be necessary, discuss the options available to provide the appropriate information to the external auditor or others.



The dust has settled—what is the remediation plan?

After the investigation is complete, the important task of devising a remediation plan falls to the investigation team and the audit committee. Depending on the circumstances, the remediation effort can be extensive and lengthy. Management will need to devote appropriate resources and establish a process to keep the audit committee updated on progress.

Important questions to consider when recommending remedial action for management include:

- Who was aware of or participated in the wrongdoing?
- What actions were taken or should have been taken?
- What policies, procedures or internal control modifications are needed to prevent a recurrence?

Remediation plans should also address any situations in which management or the external auditors will be unable to rely on the representations of those individuals involved. Objectivity continues to be vital. Outside advisors can play a key role helping the committee make well-informed decisions, especially when decisions involve members of senior management.

The company's system of internal control over financial reporting must also be assessed to note if any deficiencies existed and whether they rose to the level of a material weakness.



Overseeing or leading an investigation is a critical responsibility of the audit committee. Having the right investigation team and approach is important. Being prepared and devising and executing a high-quality investigation will provide value under challenging circumstances.



How PwC can help

To have a deeper discussion about how this topic might impact your business, please contact your engagement partner or a member of PwC's Governance Insights Center.

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