

Audit Committee Excellence Series

Achieving excellence: Dealing with investigations

June 2015

PwC's Audit Committee Excellence Series (ACES) provides practical and actionable insights, perspectives, and ideas to help audit committees maximize committee performance. This edition addresses key considerations related to the committee's role in investigations.

This ACES module addresses key considerations related to investigations, including:

1. Why investigation decisions are critical to audit committees
2. Adequate preparation can make a big difference
3. Making decisions when an allegation surfaces
4. Performing an investigation
5. Responding – once the dust settles

1. Why investigation decisions are critical to audit committees

Corporate investigations are on the rise, and the expectation is for these fact finding exercises to be appropriately and objectively governed. Often, this responsibility falls to independent members of the board of directors, and more likely than not, audit committee members will be asked to oversee an investigation at some point. For most, it is not a matter of if, but when.

Issues triggering an investigation are broad and can range from financial reporting fraud, conflicts of interest, harassment, and violations of laws and regulations, to retaliation against whistleblowers. In addition, the increased prevalence of cyber-attacks against corporations in recent years may trigger the need for investigations into the nature, timing, and extent of the breach. And the heightened focus on bribery and corruption by regulators around the globe has triggered many inquiries regarding those issues.

Decisions about investigations are often directed to the audit committee since they are generally charged with the oversight of compliance activities and the majority of them are also responsible for the oversight of IT¹. This edition of ACES focuses on the critical role audit committees play in responding to allegations and provides practical advice on how to prepare for, execute, and respond after an investigation.

Corporate investigations are on the rise, and the expectation is for these fact finding exercises to be appropriately and objectively governed.

2. Adequate preparation can make a big difference

Allegations, especially when raised publicly, can send a company into a tailspin. Pressure to complete the investigation quickly and focus from outside constituents, including external auditors, regulators, and plaintiffs' counsel, should be expected. Proper

preparation can yield great dividends by facilitating a speedy response, averting missteps, and executing a thoughtful and efficient investigative process.

Capturing and communicating allegations

Directors should expect management to provide them with periodic and prompt communications regarding significant allegations. It is advisable that management captures allegations not only from the company's formal reporting process or hotline, but also from other sources, including lawsuits, inquiries from regulators, complaints to managers, and findings from internal audits. Management and the audit committee should agree on a framework to categorize allegations so that the audit committee can easily identify significant matters that require their prompt attention. Finally, the cadence and format of reporting should be agreed and adjusted as needed.

Lining up the right external legal counsel

Legal counsel usually plays a critical role in addressing the need for, and in performing, an investigation. Lawyers share their perspectives on the implications of an issue, give guidance on the procedures to be performed, discuss necessary disclosures, accommodate "privileged" information status, and can help advise on potential legal liability. The use of external legal counsel can refute the suggestion that an investigation was inadequate because of a lack of independence and conflicted roles of an internal investigation team. Companies should consider identifying external legal counsel that could be used to advise on, or conduct an investigation in advance of any potential issue, including keeping them "on-the-shelf." This means the law firm selected should not have performed significant (or any) legal services for the company prior to being engaged for a potential investigation. This ensures the firm is objective.

It is critical that when external legal counsel becomes involved, they satisfy stakeholder expectations by having the credibility and appropriate skills, experience, and reputation to handle the type of issue alleged. For this reason, a company may have different external legal counsel identified and retained for various events that can occur at a company.

Considering communications with stakeholders

When significant trouble confronts a company, it is important to manage communications with key stakeholders—shareholders, employees, vendors, lenders, auditors, and regulators. A robust internal and external communications plan is often necessary. Accordingly, some companies also identify a public

¹ PwC's Directors and IT: What Works Best TM

relations firm in advance of the crisis. Many companies also establish internal communication guidance in advance that provides protocols for discussions with external parties, the format of the communications, identifies the company spokesperson, etc.

Knowing key regulatory contacts

A company may need the assistance of, or be required to deal with, regulators during an investigation. It can be helpful for companies to identify the relevant agencies and even reach out to these organizations before an event occurs. Different regulators may need to be identified based on the type of event. For example, the FBI may need to be contacted regarding potential cybercrime concerns.

Performing table-top exercises

“War-game”-like exercises can be a powerful tool to improve the likelihood of an effective and efficient response to an allegation of wrongdoing. Such exercises can help a company understand how such an event would unfold and help senior executives and directors understand their roles and responsibilities.

Audit committee considerations:

- Evaluate whether the company has established appropriate procedures for cataloging and evaluating allegations of wrongdoing, and for promptly communicating significant issues to the audit committee.
- Consider whether qualified and objective advisors, such as legal counsel and other advisors should be identified in advance.
- Consider whether the company has an adequate communication plan and internal protocols in place.
- Discuss with management the appropriateness of establishing contacts with key regulators.
- Consider conducting a “table-top” exercise to test the company’s response plan.

3. Making decisions when an allegation surfaces

It is important that when a company is informed of questionable behavior, an investigation decision is made as soon as possible. There are no prescribed procedures or panacea when it comes to making this call. However, once informed, companies will want to conduct initial fact finding procedures to understand the nature and substance of the allegation. They will

then need to exercise significant judgment to decide whether an investigation is needed.

Each situation is unique and specific to a company’s facts and circumstance but, in many cases, directors must “weigh in.” Consideration should be given to the magnitude, severity, potential reach, and the comfort level with responses to questions raised during the discovery process. In evaluating the need for further investigation, the company should consider whether the situation could materially impact reported results, operations, or internal controls or whether senior management could be involved. Other factors include the potential business and legal consequences, the inference of an illegal act, as well as whether the issue relates to conduct on behalf of the company or is personal. Consultation with resources such as legal counsel or other experts can also help, and may be a necessity.

The process of addressing such allegations can be extremely stressful and time-consuming. The decision can have a significant impact on shareholders, employees, and the company’s reputation and bottom line. The company may need to consider whether to put an employee on leave and appoint an interim person to fulfill their role. Not effectively addressing an allegation can result in negative press, such as a continuing storyline about a botched investigation, which can further damage the brand of the company and increases the potential for litigation. Further, proxy advisory firms have recommended against voting for directors who failed to undertake credible investigations.

4. Performing an investigation

Selecting the investigation team

When an investigation is launched, the audit committee should ensure that the right investigation team is put in place. The initial consideration is whether the investigation should be conducted using internal resources or independent third-parties.

Internal resources may be appropriate to conduct certain investigations. But it is important to consider whether those resources are objective and whether they will satisfy the needs of key stakeholders, including external auditors and regulators. Frequently, the internal legal or internal audit departments conduct investigations into less significant allegations. Using internal resources can be efficient and cost effective by leveraging institutional knowledge. However, internal resources cannot always provide the objectivity or experience required

to address more significant issues. Two common examples include allegations against senior executives and investigations that require expertise or language skills that exceed the capabilities of the internal team.

Similarly, the inclination may be to have the company's regular external legal counsel conduct the investigation because they "know the company." However, their ties to management can impair their ability to be objective, especially when this same counsel plans to also potentially defend the company or individual accused in a litigation or regulatory investigation. A good rule of thumb is that the level of independence needed by legal counsel is directly proportional to the seriousness of the alleged issue. Carefully considering the choice of investigator at the outset can eliminate inefficiencies due to having to change teams later in the investigation process. However, it is often necessary to revisit the decision on whether to engage independent legal counsel as an internal investigation progresses.

If the potential exposure to economic loss or litigation is significant, or if executive management could be involved, an investigation is usually overseen at the board level (often the audit committee) or by a "special committee" of the board (often including members of the audit committee). In situations where there are credible allegations of serious corporate wrongdoing, it is usually prudent to appoint a "special committee" of the board with mandated specific investigation oversight responsibilities and comprised of disinterested independent parties. Selecting members for the "special committee" should be handled with great care. Regardless of who oversees the investigation, it is important for the investigation team to have a clear understanding of the nature and frequency of reporting to the oversight committee.

Establishing scope and procedures

After establishing appropriate oversight and settling on an investigation team, the first task of the newly formed team is to define the scope of the planned investigation. They should clearly articulate the questions they have been retained to answer and the investigative procedures they intend to perform. One common scoping mistake is to fail to consider the expectations and needs of relevant stakeholders. Typical procedures include the identification and review of electronic financial records, system access logs, emails, interviews, and reviews of company books and records. It is important that the team be allowed to independently establish their scope and procedures based on their experience and given the allegations they've been retained to investigate. This plan is usually shared with external auditors and

sometimes even regulators, who can provide valuable feedback, in addition to being approved by the investigation oversight committee.

A company will want to conduct a robust investigation to ensure that issues have been identified and corrected. There have been numerous situations where a company announced the results of an investigation and had to subsequently revise restated financial information or, in the case of a cyber-breach, the disclosure of the number of customers affected. Audit committees will also want to be mindful that many investigations take unexpected turns along the way as additional findings come to light.

Keeping the investigation oversight committee informed

During the investigation, regular communications with the oversight committee are essential. As to external communications, companies will want to focus on the messaging, being careful not to provide erroneous details before all the facts are known that may need to be redacted or corrected. And yet, not wait too long before disclosing the issue. It is a delicate balance and outside expertise may be needed.

Audit committee considerations:

- Be comfortable that the right team is engaged to perform the investigation.
- Evaluate the need for a "special committee" of the board.
- Establish clear lines of reporting from the investigation team to the oversight committee.
- Allow objective investigators to establish an appropriate scope and investigative procedures.
- Plan for the flexibility in an investigation – things often don't play-out as expected.
- Discuss the internal and external communication protocols with management.

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Potentially challenging areas that deserve attention

Investigation oversight committees should understand that it can take months or even years for a company to identify the full extent of an issue as they often relate to an extended period. Investigations often take a lot longer and cost a lot more than originally anticipated. There can be considerable pressure to rush through the process for obvious reasons. This pressure can add to the risk that an investigation will not prove to be adequate.

A potential mistake is for the investigation team to not retain sufficient documentation of the procedures performed and then being unable to adequately support the results of the investigation to the scrutiny of stakeholders.

Relevant regulators may also expect or encourage the company to self-report and to provide periodic status updates. The decision to self-report is complicated. This is a separate, but related, question to the one of whether the matter needs to be disclosed in an SEC filing. On both questions, however, the advice of counsel is critical.

If the allegations could be material to the company's financial reporting (qualitatively or quantitatively), the company may decide to delay its SEC filings until the investigation can be completed. Delays can trigger declines in stock price, non-compliance with loan covenants, and restrict access to the capital markets. These unwelcome consequences underscore the importance of timely communication, as unnecessary delays resulting from the failure to communicate can be costly. Similarly, deficient or erroneous communications to investors that needs to be frequently updated or corrected can undermine credibility.

Monitoring progress

Once the investigation is started, the committee overseeing the investigation will want to be informed about progress. Regular communications regarding findings and previously unidentified issues are imperative. The committee will want to continue to provide their perspectives on whether the planned scope of the investigation is appropriate, or whether it should be expanded or reduced based on findings to date.

Companies should be mindful that dealing with an investigation can take a tremendous amount of management's time and energy. It can be easy for management to lose the balance between focus on the investigation and keeping the business on track. Investigation teams and their boards should be

sensitive to this concern and make certain that management doesn't become overly absorbed in the investigation process. One common mistake investigation teams and audit committees make is to cut management out of the communication loop completely during an investigation. While it is important not to discuss details of the investigation scope, procedures, or findings with any potential witnesses, members of management need periodic status updates so that so that they can plan and perform their job duties effectively.

Communicating the final results

Once the investigation is complete or nearly complete, attention should turn to documenting and communicating the findings. If, how, and when to prepare a report of investigation is a subject of much debate. Some investigators routinely prepare detailed written reports. Others prefer to document their work in bullet point outline format in a slide deck. Still others will not prepare a written report at all, and would rather communicate their findings to stakeholders orally.

There is no one correct answer, but it is critical that these options are considered as early in the process as possible. However documented, the investigation findings will be scrutinized and ultimately used by stakeholders, including management, external auditors, and regulators.

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

- Findings should be thoughtfully crafted as they will form the basis of future public disclosures, if any.
- Management will need documentation of the investigation procedures and findings to substantiate their assessment of the impact on financial reporting and internal controls.
- When a report is prepared, regulators, external auditors or others will likely request access. If written privileged communications are thought to be necessary, consider preparing a separate document apart from an unprivileged report of investigation, which can then be shared freely.
- The audit committee and the company may prefer to have a written record of their response to the allegation to demonstrate that they fulfilled their fiduciary duties.

Audit committee considerations:

- Discuss the company's public disclosure and reporting obligations to regulators; consider self-reporting.
- Solicit the advice of outside experts.
- Monitor progress and ensure management stays focused on running the business.
- Carefully consider the pros and cons of various reporting formats and retain appropriate documentation to support procedures and findings.
- Understand the role external auditors and forensic accountants have in the investigation.
- Consider the possible need to disclose certain aspects of the allegations or findings.

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5. Responding - once the dust settles

After the investigation is complete, the important task of responding to the information uncovered and recommending appropriate remedial action falls to the investigation oversight committee, with the help of advisors, especially when these decisions involve members of senior management. Important questions to consider include who participated in the wrongdoing, who was aware of it, what actions did they take or should they have taken, and should others have known. At this juncture, objectivity is vital and outside advisors can play a key role helping the oversight committee in the making well-informed decisions along with the perspectives of important stakeholders. The company's internal control system must also be assessed for deficiencies and necessary related public disclosure.

Audit committee considerations:

- Solicit input from experts on the adequacy of remedial actions.
- Take appropriate disciplinary actions post-investigation, ensuring that they establish the right "tone at the top" and corporate culture.
- Understand if responses to investigation findings meet the expectations of the regulators.
- Understand identified weaknesses in internal controls and evaluate necessary disclosures.

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 Center for Board Governance.

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Other topics

Other "Audit Committee Excellence Series" topics include:

- Assessing the company's forward-looking guidance practices and the potential risks of consensus estimates (March 2014)
- Financial reporting oversight (May 2014)
- Overseeing internal audit (July 2014)
- Overseeing external auditors (September 2014)
- Overseeing accounting changes—including the new revenue recognition standard (February 2015)
- Role, composition, and performance (May 2015)

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