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EIGHTEEN SAFEGUARDS TO AN AUDIT COMMITTEE'S INVESTIGATION OF FINANCIAL REPORTING

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PERSPECTIVES
EIGHTEEN
SAFEGUARDS TO AN
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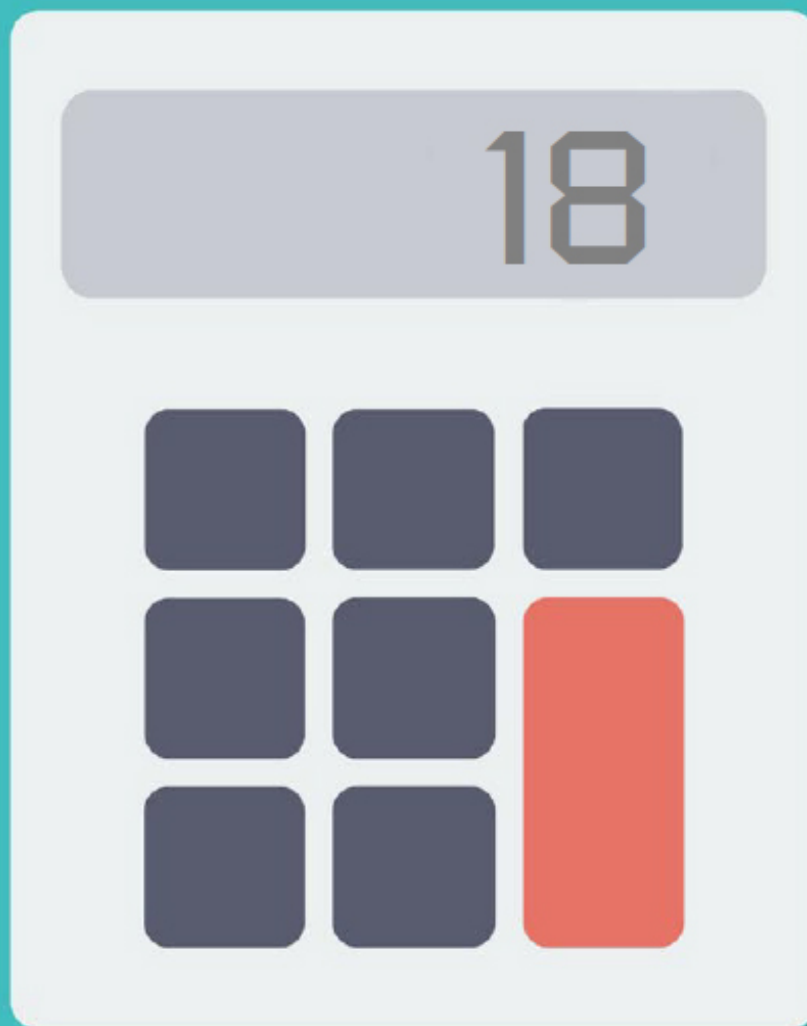
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As the financial crisis recedes into history, the SEC has renewed its focus on fraudulent financial reporting. It has created a new Financial Reporting and Audit Task Force with enhanced capabilities to seek out and uncover improper accounting, and it has made clear its determination to bring enhanced resources to accounting investigations.

Any audit committee that has been through one knows that an internal investigation of a company's accounting can be a source of great frustration.

Often, accounting investigations seem to take too long, cost too much and leave the company in legal limbo – or, worse, legal freefall – for way too long. Sometimes, those in charge seem to have lost sight of the fact that the objective of the investigation is to fulfil a practical business need.

Nonetheless, attempts at shortcuts have rarely seemed to work out. And both the SEC and independent auditors of financial statements have proved to be exacting audiences for audit committee investigative reports.



For its part, the SEC has made clear its frustration with audit committee investigations lacking in thoroughness and objectivity. Alarming to many audit committees, the SEC has pursued enforcement actions against audit committee members who, faced with potential evidence of fraud, in the SEC staff's view did not sufficiently fulfil their 'gatekeeper' responsibility.

As to the independent auditor, in addition to the requirements of professional standards, an amendment to the US Securities Exchange Act of

1934 calls upon the auditor to evaluate whether a company encountering illegal acts materially affecting the company's financial statements is taking "timely and appropriate remedial actions". If the auditor determines the company is not, the auditor may have to provide a report to that effect to the company's board of directors, which then has 24 hours to inform the SEC. Failure of the board to do so may require the auditor, within 24 hours thereafter, to notify the SEC itself.

So, it is a good time to take a fresh look at audit committee investigations of financial reporting. While the needs of any investigation will necessarily depend upon the circumstances, certain procedures, established at the outset, can act as a safeguard against undue compromise of an investigation's adequacy and objectivity. It may be that, in some investigations, not every safeguard is warranted. Still, it is probably useful that they at least be considered.

Eighteen Safeguards

1. An internal investigation of potential fraudulent financial reporting at a public company should normally be overseen by the audit committee.
2. This investigation should be undertaken by a law firm of recognised reputation and capability that has little or no prior history of reporting to management. For potentially serious financial reporting issues, regular outside counsel, or defence counsel in parallel litigation, will rarely suffice.
3. The law firm, under normal circumstances, should engage forensic assistance.
4. The investigation may initially focus on particular issues but is not to be unduly constrained in scope. In assessing scope, the audit committee should be attentive to the materiality guidance of SEC Staff Accounting Bulletin No. 99.
5. It is useful for the investigators to consult with the independent auditor at the outset to ensure that the proposed scope of the investigation will be sufficient for audit purposes. To avoid diverging expectations, the auditor's views as to continuing scope adequacy should be periodically sought.
6. The audit committee, as a matter of substance and tone, should express a willingness to actively oversee the investigation and assume responsibility for its results. It is the audit committee that should select and engage the law firm responsible for conducting the investigation. It is similarly the audit committee to whom the investigators should report.
7. The audit committee should do its best to see that company personnel cooperate with the investigation in both substance and spirit. Personnel should be expected to make themselves available on request, make available requested documents and be candid with the investigators.
8. The audit committee should consider the need to put in place procedures to ensure that executives potentially involved in misconduct are not informed or updated as to substantive progress or tentative findings. Executives should not have prior substantive contact with individuals being interviewed on the subjects into which inquiry is being made.
9. The audit committee, in conjunction with its counsel, should consider the extent to which initial disclosure regarding the investigation may be needed with due cognisance being given to the expectations of regulators who may evaluate such a decision with the benefit of hindsight. To avoid miscommunication, draft press releases are best made available to the auditor for review.

10. The investigation should proceed with utmost efficiency but should not be compromised by upcoming deadlines for the filing of a Form 10-K or other such constraint. An auditor or regulator will normally be sensitive to whether the scope, quality or depth of an investigation is being compromised by deadlines.

11. The auditor will often seek 'complete transparency' between the conduct of the investigation and the information available to the auditor. Assertions of attorney-client privilege will not normally be accepted where such assertions impede access to investigative processes or findings.

12. The audit committee should consult its counsel as to cooperation with the staff of the SEC. The auditor's responsibility to evaluate the company's "timely and appropriate remedial actions" will often include auditor cognisance of the audit committee's approach to SEC cooperation.

13. On particular issues, investigators may find evidence going both ways – both incriminating and exculpatory. The auditor should be expected to seriously consider incriminating evidence in assessing appropriate remedial actions and the auditor's acceptance of management representations.

14. Upon the investigation's completion, the investigators should provide a report setting forth, among other things: (i) the circumstances giving rise to the investigation; (ii) the investigation's scope; (iii) the persons interviewed; (iv) sources of documents reviewed; (v) the underlying facts; (vi) determinations as to wrongful intent; and (vii) proposed remedial action. The auditor and the audit committee should discuss, optimally at the outset, whether the report

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should be in writing with appropriate cognisance being taken of the needs of relevant regulators. Regardless of whether a written report is prepared, the auditor should be expected to document important aspects of the report in its work papers.

15. Upon the investigation's completion, the auditor will assess the reasonableness of the scope, objectivity and findings of the investigation and the extent to which the investigation can be relied upon for the purpose of issuing an audit report.

16. The auditor will separately assess the extent to which the company has taken “timely and appropriate remedial actions” pursuant to US Securities Exchange Act Section 10A. An important aspect of that assessment will often involve the extent to which remedial action regarding particular employees is consistent with the investigative findings.

17. The audit committee and management will often be called upon to provide representations regarding the investigation and any financial statements affected by its findings.

18. Throughout the investigation, and upon its completion, the audit committee and its counsel should assess the extent to which additional public disclosure is appropriate. Such disclosure is best made available for auditor review prior to issuance.

Conclusion

The objective of an audit committee investigation is to help the company put the problem behind it

– not to make it worse. Inadequate investigations can anger regulators and make the procurement of an audit report on a company’s financial statements exceedingly difficult. A thorough investigation, overseen by the audit committee and undertaken by sophisticated professionals in a way that safeguards the objectivity of the determinations, best serves the interests of a public company and its shareholders.

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