Eighteen Safeguards To Corporate Self-Investigation

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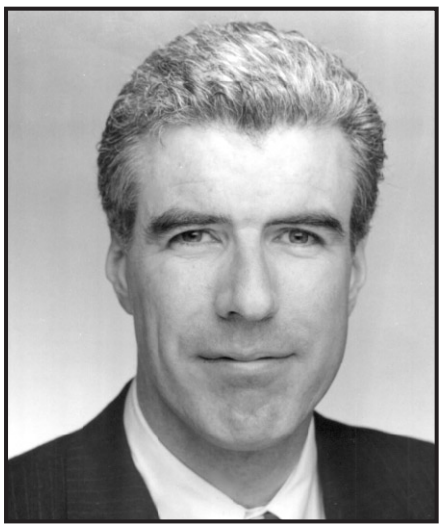
Introduction

Over the past several years, there appears to have been an increasing need for investigations into potential accounting issues at public companies. The need has corresponded, not surprisingly, with an upsurge in reported restatements of financial statements. Where such a restatement is potentially the result of deliberate misconduct, an internal investigation may be necessary both to correct financial misstatements and to demonstrate the sufficiency of the company's remedial action to the SEC, the Department of Justice, or the outside auditor of the company's financial statements.

As some corporate boards have discovered to their woe, the perils in undertaking such an investigation are many. Sometimes they are overseen by a board committee that is later found not to have possessed sufficient independence. Sometimes the law firm engaged by the board's special committee is itself insufficiently independent or not sufficiently sophisticated for the task. Sometimes management interferes with the investigation and the credibility of the investigative conclusions are compromised thereby.

Of late, both the SEC and the auditors of financial statements have proved to be particularly tough audiences for special committee investigative reports. Both have demonstrated a strong interest in internal investigations that are independent, thorough, and unlimited in scope. Moreover, both have demonstrated an intolerance for investigative reports that appear to exonerate executives when exoneration does not appear to be completely justified by the facts. With regard to the SEC, the price of an inadequate investigation may include increased regulatory zeal. With regard to the outside auditor, the price may include a failure to obtain an audit report on restated financial statements and, in serious cases, a "10A report" in which the auditor alerts the SEC that the board of directors is not taking "timely and appropriate remedial actions."

While the needs of any investigation will necessarily depend upon the circumstances at issue, experience teaches that certain procedures, established at the outset, can act as a safeguard against undue compromise of an investigation's independence and effectiveness. They are listed below. It may be that, in some investigations, not every safeguard is warranted and that,



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indeed, not even most of the safeguards would be needed. Still, it is probably useful that they at least be considered:

Eighteen Safeguards

1. An internal investigation of potential accounting irregularities at a public company should be overseen by an audit committee comprised solely of independent directors or by a similarly comprised special committee of the board (hereinafter referred to simply as the "audit committee").

2. The investigation should be undertaken by a substantial law firm of good reputation that has no prior history of reporting to management. Regular outside counsel, or defense counsel in related litigation, will rarely suffice.

3. The law firm under normal circumstances must engage an accounting firm to provide forensic assistance.

4. The investigation may initially focus on particular issues but is not to be impeded by unreasonable constraint. The investigators are to have license to pursue all evidence of potential improprieties no matter where they may lead. In this regard, SAB 99 may provide useful guidance as to materiality.

5. The investigators should consult with the auditor at the outset to ensure that the proposed scope of the investigation will be sufficient to be relied upon for audit purposes. Throughout the course of the investigation, the auditor should be periodically apprised of the extent to which the scope remains adequate or needs to be expanded.

6. The audit committee, as a matter of substance and tone, must express a willingness to actively oversee the investigation and assume responsibility for its results. It is the audit committee that is to select and engage the law firm responsible for conducting the investigation, and it is the audit committee to whom the investigators are to directly report.

7. The audit committee is to see that all company personnel are encouraged to cooperate with the investigation in both substance and spirit. Company personnel are to make themselves available on request, to cooperate to the fullest extent possible, to make available all requested documents, and to be truthful and candid with the investigators.

8. The audit committee should consider the need to put in place procedures to ensure that executives or employees potentially involved in misconduct are not informed or updated as to investigative progress or tentative results. Executives should not have the opportunity to interfere with the investigation or have any 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 and its subject matter may be needed. Draft press releases should be made available for review by the auditor.

10. The investigation may proceed with all available dispatch, but is not to be compromised by inordinate management pressure, upcoming deadlines for the filing of a Form 10-K, or other artificial constraint. The auditor will not permit the scope, quality, or depth of an investigation to be compromised by deadlines.

11. The auditor will often seek "complete transparency" between the conduct of the investigation and the information available to the auditor. In other words, the auditor may not accept, as justification for lack of access to information, assertions of attorney-client privilege or work product. The auditor will ordinarily want to determine, as a matter of its own judgment, those investigative materials it will want to review. The auditor may view a failure to provide those materials as a scope limitation to the audit.

12. The audit committee should consult its counsel as to its responsiveness and cooperation with the staff of the SEC in connection with an SEC investigation. That issue should be discussed as well with the auditor insofar as the audit committee may request the auditor to accompany company personnel in SEC presentations.

13. On particular issues, investigators may find evidence going both ways – both incriminating and exculpatory. The audit committee should understand that the auditor will consider incriminating evidence in assessing appropriate remedial action and its willingness to accept representations from particular individuals.

14. Upon the investigation's completion, the investigators should provide a report setting forth, among other things:

- the circumstances giving rise to the investigation;
- the investigation's scope;
- the persons interviewed;
- sources of documents reviewed;
- the underlying facts;
- conclusions as to culpability and intent;
- the numerical explication of any necessary adjustments to the company's financial statements; and
- proposed remedial action.

The auditor and the audit committee should discuss whether the report should be in writing with appropriate cognizance being taken of the needs and desires of relevant regulators. The audit committee should understand that, regardless of whether a written report is prepared, the auditor will normally document important aspects of the report in its workpapers.

15. Upon the investigation's completion, the auditor will assess the reasonableness of the scope, findings, and conclusions of the investigation and the extent to which the investigation can be relied upon for 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 section 10A of the 1934 Act. An important aspect of that assessment will often involve the extent to which company personnel have been forthright and candid with investigators and company stakeholders.

17. The company will be called upon to provide representations with regard to the investigation and any financial statements affected by its conclusions. The audit committee and investigators should be mindful, throughout the investigation, that the auditor may not be in the position to accept audit-related representations from management as to whom there is evidence of wrongful conduct.

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 should be reviewed by the auditor prior to its issuance.

Conclusion

The objective of an internal investigation is to help the company put the problem behind it – not to make the problem worse. Inadequate investigations can anger regulators, make difficult or impossible the procurement of new audited financial statements, and increase the apparent guilt of those who may have done something wrong. A thorough and independent investigation, undertaken by sophisticated professionals in a way that safeguards the integrity of the outcome, serves the interests of a public company, its board of directors, its regulators and auditor, and its shareholders.

***Michael R. Young** is a litigation partner in the New York office of Willkie Farr & Gallagher LLP specializing in securities and financial reporting. You may reach Mr. Young at (212) 728-8000. A special thanks to PLI All-Star Briefing which first enumerated the 18 Safeguards referred to herein.*

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