

# In readiness for an internal investigation

*Boards should be prepared to undertake complex and wide-ranging internal investigations. Develop a plan now to deal with the inevitable.*

**BY LEE M. DEWEY AND PETER C. SPRUNG**

**I**N TODAY'S REGULATORY CLIMATE, board members are increasingly being held accountable for monitoring company operations and acting decisively in response to alleged improprieties. One of the tools for discharging this duty is the corporate internal investigation. Over the past several years, the number and scope of such investigations have been growing for a number of reasons, including new whistleblower protections, enhanced law-enforcement activities, and more assertive independent auditors. Even so, board members and corporate representatives tend to view a whistleblower complaint or government investigation as an unexpected event. Thus, many are left unprepared when a genuine crisis hits.

It doesn't have to be this way. Like other business contingencies, the risk of financial wrongdoing and the subsequent need for an appropriate response can be planned for and managed effectively. Moreover, although internal investigations often raise sensitive and difficult questions, those questions can be anticipated. To be sure, there is no one formula that can be applied uniformly to every internal in-

vestigation. Boards must use a flexible approach that takes account of the particular circumstances presented by each investigation. Nonetheless, using the guidance set forth below and with advice from capable legal counsel, a forward-looking board can develop a coherent policy for conducting corporate internal investigations.

Corporate internal investigations typically present certain recurring questions and problems for board members to address. Based on our experience with investigations conducted for a variety of publicly traded and private organizations, we recommend that boards assess their readiness to undertake internal investigations and develop an appropriate policy in light of the following issues and criteria.

## Growing demands

Over the past several years, the number and scope of corporate internal investigations have been growing. According to the President's Corporate Fraud Task Force, since 2002 the U.S. Department of Justice has obtained more than 500 corporate fraud convictions or guilty pleas, and charged more than 900 defendants and over 60



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corporate CEOs and presidents. Moreover, published reports indicate that from Jan. 1, 2004 to Nov. 15, 2004, more than 135 investigations were conducted by the Department of Justice, the SEC, and corporations themselves concerning securities fraud and other financial misconduct.

Several factors are contributing to this trend:

- New whistleblower protections make it easier for employees to report potential wrongdoing.
- Regulators and law-enforcement officials are devoting more attention and resources to alleged corporate misconduct.
- Audit committee members and other directors, fearful of personal liability, are watching management and auditors more carefully.
- Independent auditors are spending more time on the audit process and are questioning management more often.
- Attorneys have new professional responsibilities to report evidence of wrongdoing.

**Risk assessments and profiles**

Although all organizations experience fraud, the types of fraud that occur in a particular organization typically vary according to several factors, including the size of the organization, the type of business in which it is engaged, the quality of its internal controls, and its corporate culture. In order

to understand these factors fully, the board should assess the types of depredations to which the company is likely to be most susceptible. This assessment should include a critical examination of the company’s business practices, its prior history, and the prior compliance record of both the company itself and the in-

dustry in which it operates. Board members should also understand the “red flags” that typically occur in the industry. Using this information, the board should develop a risk profile for the company that can be used to organize its fraud-prevention efforts going forward and inform its approach to internal investigations.

**Sources of information**

The information that triggers an investigation may originate from a variety of sources, including a

whistleblower, an independent or internal auditor, customers, suppliers, analysts, a regulator, and a law-enforcement agency. Depending on the nature of the source, different issues can arise. For example:

- If the independent auditor finds an accounting irregularity or a defect in internal controls, the board must be prepared for the possibility that the auditor will “put down its pen” until the issue is adequately addressed.
- If the information is raised by a whistleblower, the board must take steps to ensure that the whistleblower’s rights are protected.
- If the company receives a subpoena from the government, it must consider whether to inform its shareholders and the public about the law-enforcement investigation. It must also take vigorous steps to preserve the underlying evidence from loss or destruction.

The board should consider each of the various scenarios in planning how to handle an internal investigation.

To ensure that the board gets timely and relevant information about alleged misconduct, a system should be developed for monitoring complaints received through the sources described above. This system would ensure that the board is immediately informed of allegations of wrongdoing involving senior management or other issues that would create a conflict of interest if resolved by management. Yet the system should ensure that the board will not be deluged with less consequential complaints that do not merit its attention.

**The initial assessment**

The board should provide a means for the company’s legal counsel to make an initial assessment of the situation. This would include a review of the underlying allegations, a preliminary interview of knowledgeable witnesses, and an analysis of the appropriate scope of the investigation. Preliminary witness interviews should be conducted in the presence of counsel in order to preserve the attorney-client and work product privileges.

At this stage, the board’s investigative policy should focus decision-makers sharply on the intended goals of the investigation. In addition to determining the underlying facts, the goals may include:

- Identifying and stopping improper conduct.

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- Understanding complicated financial transactions and accounting issues.
- Complying with legal or regulatory requirements (such as Sarbanes-Oxley).
- Preparing a defense for anticipated government enforcement proceedings or civil litigation.
- Facilitating self-reporting in order to mitigate civil, criminal, or regulatory sanctions.
- Identifying and pursuing potential civil claims by the company against wrongdoers or submitting appropriate insurance claims under fidelity and other coverage.
- Reassuring important constituents, such as shareholders or customers.

Identifying the goal of the investigation will drive other important decisions, such as the ones described below.

### Investigative functions

A crucial issue for the policy to cover is who will supervise the investigation. This person will have the power to determine whether the investigation will be a fair and thorough exercise or whether it will simply reach a preordained result. In this regard, the board's policy should account for the possibility that members of management or the board may have participated in the transactions under investigation, been exposed to red flags about the misconduct, or approved the flawed financials. The policy should allow for the appointment of independent directors to lead the inquiry under appropriate circumstances.

Directors should canvass human resources, both inside and outside the company, who may be needed to handle internal investigations effectively. The board would do well to compile a list of legal, accounting, investigations, public relations, and other experts whom it can call upon in the event these services are needed.

*Lawyers:* The board's policy should address whether in-house or outside counsel will be used for the investigation. Assuming the board chooses outside counsel, the policy should also cover whether the company's regular outside counsel or another law firm will be hired. The board should consider counsel's independence and prior experience with the type of investigation in question.

The policy should also cover how the company

will respond to government investigations. This is a particularly sensitive issue, since cooperating with the government will likely result in the disclosure of the findings of the internal investigation to the government and, ultimately, to plaintiffs' class-action lawyers. When interviewing potential outside counsel, board members should inquire about the firm's approach to this issue.

*Accountants:* The board should plan for the retention of appropriate financial and accounting experts. Forensic accountants understand how independent auditors work, what their responsibilities are, and the limits of their charge. Accountants also understand companies' internal controls, financial reporting, financial disclosure, bookkeeping, and audit committee practices. Because they are intimately familiar with complex accounting literature and relevant interpretations, these accountants can grasp complex GAAP issues that typically arise in fraud investigations, such as the timing of revenue and expense recognition, and can identify "red flags" that might not be apparent to the untrained eye. They can also participate in interviews of key witnesses as well as presentations to outside auditors, regulators, and law-enforcement agencies.

*Investigators:* Another important function to be covered by the policy is that of the investigators. Accomplished investigators have advanced skills in computer forensics, witness interviewing, background checks, and physical surveillance. Ideally, the accounting firm will be able to provide these services, enabling the investigation to proceed in an efficient and cost-effective manner.

### Scope of the investigation

The board's policy should grant the investigators the authority to explore the underlying allegations fully. While it is reasonable for the policy to allow consideration of the cost and potential disruption of the investigation, the board should not compromise the thoroughness and independence of the investigation in the name of business expediency.

The policy should also account for the fact that during the process, investigators commonly encounter indicators of wrongdoing that were not known at the outset. If such evidence is unearthed, the plan should allow for appropriate arrangements

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to be made for investigation of these new lines of inquiry.

**Communications with employees and the public**

The board and senior company representatives should clearly communicate the importance of the investigation to employees and insist that all personnel fully cooperate with the investigators. As for public communications, the board’s policy should encourage company representatives not to make any public statements about the facts until the investigation has been completed.

**Preventing further damage**

Under the terms of the policy, corporate representatives must be responsible for taking action to prevent further damage if the board is informed

or suspects that the misconduct is ongoing. These steps could include limiting the access of alleged wrongdoers to company funds or files or even suspending them from the workplace altogether. At the same time, the board may be advised

to manage information about the investigation on a “need to know” basis so the investigators can go about their work unimpeded. The policy should require the board to carefully weigh the advantages and disadvantages of each course of action with counsel and other experts.

**Acting on the findings**

Depending on the nature of the investigators’ findings, the board may have to respond. Questions directors may need to consider include the following:

— Have any regulatory requirements been triggered?

— Must representations be made to auditors, regulators, or law enforcement?

— If so, how should those disclosures be framed?

— What are the effects of the findings on the company’s present or prior financial statements?

The board should also consider what insurance coverage may be available and make any required notifications to carriers.

In addition, the board may have to decide whether to discipline individuals found to have been implicated in wrongdoing and take steps to recover any ill-gotten gains. For example, if the company’s financial statements must be restated to correct material misrepresentations, the board may act to recapture performance-based compensation from responsible officials. Regulators, law-enforcement authorities, and the company’s own employees will be watching closely how the board handles this sensitive issue. One of the quickest ways for a company to discredit its investigation is to go easy on a miscreant simply because he is a “big producer.”

The board should consider taking steps to ensure that misconduct is not repeated, including developing more effective internal controls and procedures. The policy should call for consideration of these issues.

**A prepared board**

In an era of increasing scrutiny of alleged corporate misconduct, boards should be prepared to undertake complex and wide-ranging internal investigations. While it is impossible to anticipate every scenario that may arise in the course of such investigations, certain issues tend to arise more frequently. A conscientious board can develop a coherent policy for dealing with the inevitable. ■

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