

Selecting the Right Investigative Resource

When does an allegation of financial statement fraud call for an in-house investigation, and when is hiring outside experts prudent?

by Greg Regan, CPA/CFF,
and Kristín Rivera, CPA/CFF

It's Friday at 4 p.m., seven days before the filing deadline for an SEC registrant's annual financial statements. The general counsel has just received a detailed but anonymous e-mail alleging improper revenue recognition at the company's Chinese subsidiary and must decide what to do next.

This scenario, enough to panic audit committee members, CEOs, CFOs, general counsels, and internal and external auditors alike, calls for an appropriate response. What should that response be? Should the external auditors be notified and, if so, what should they be told? Will the filing deadline be met? Often, the most pressing question is how to assemble a team to address the allegation appropriately and efficiently.

These early decisions are often the responsibility of the audit or other authorized committee of the board. Frequently, the committee will look to management, in-house counsel or internal audit for support in gathering data necessary to inform the committee's decisions. This is acceptable so long as objectivity is preserved. It is important to remember that these initial procedures are designed to determine how an allegation should be investigated and how the investigation team should be structured. This initial



assessment phase is not designed to supplant an investigation, and care should be taken to complete the assessment before beginning an investigation.

In today's challenging economy, companies are eager to preserve cash wherever possible while still maintaining good corporate governance. As a result, it is increasingly common to look to internal resources to work alongside, or in lieu of, outside investigators. This may mean using in-house counsel, IT professionals, compliance and/or internal audit per-

sonnel to lead or support the investigation. This trend raises a key question—when is it appropriate to use in-house resources to investigate allegations of financial statement fraud, and when is it necessary or prudent to hire outside experts?

To answer this question, decision makers need to understand the allegation and its possible implications. This article provides recommendations for assessing an allegation, determining how and by whom an allegation should be investigated, and selecting the right type of investigative resources.

STEP 1: IDENTIFY IMPLICATED PARTIES

As soon as possible, it is critical to make a preliminary assessment regarding who in the organization may have been involved or had knowledge of the alleged misconduct. The list should include those who are referenced in the allegation as well as those in a position to approve or otherwise have oversight into the inappropriate activities. In general, the higher up the chain of command the alleged fraud occurs, the more likely the need to look to external investigative resources.

In some cases, it is prudent to include in the probe one level of management above the highest level that is suspected of being involved in the alleged impropriety. This measure provides a “clean margin” and can be used to demonstrate that the full extent of the personnel involved in the alleged misconduct has been considered.

Once the list is prepared, determine whether investigating these individuals will put internal resources in a position to review their peers, their direct reports or their direct/indirect supervisors. Consider, for example, if the allegation of fraud in the hypothetical situation cited above involves the CFO of the Chinese subsidiary. Using local internal staff to investigate may put these individuals in the untenable position of assessing the conduct of their own boss. In this situation, it would be advisable to incorporate external resources to provide the necessary objectivity that internal resources may be unable to provide.

STEP 2: CONSIDER THE QUALITY OF PRELIMINARY INFORMATION

Another key question is whether the allegation, if true, would have a financial impact. In the example of the Chinese subsidiary, did the allegation involve a whistleblower's report that the monthly



internal financial reports were inaccurate? This may be important information from an operational perspective but, assuming the errors are corrected by the end of the quarter, may not be relevant to the financial statements. If any investigative procedures are considered to be necessary, internal personnel would likely be best suited to analyze this type of issue.

Whistleblowers sometimes get the facts wrong or make inaccurate assumptions about the facts. Therefore, it is important to determine if the alleged improprieties are improper under relevant laws, policies and procedures or if the allegation makes sense relative to the company's overall business practices, policies and procedures.

Finally, consider the source of the allegation. If the source is known, is he or she in a position to know details of the allegation? Does the allegation provide sufficient detail for follow-up? While it would be improper to dismiss an allegation simply because it is vague or the source is unknown, allegations that are rich in detail

or that come from an informed source are generally more credible.

STEP 3: ASSESS POSSIBLE MATERIALITY

Assessing the quantitative and qualitative materiality of a possible fraud before you have marshaled a majority of the facts is nearly impossible. In some cases, however, estimating the "worst-case scenario" for quantitative materiality may be possible. For example, the quantitative materiality of an alleged revenue fraud in China may be subjected to a preliminary assessment by looking at the materiality of China operations overall. In general, the more material a matter, the greater the extent of senior management's involvement, and accordingly, the more prudent it may be to ensure external involvement with the investigative team.

Qualitative materiality is more difficult to assess before more facts are known. A review of the relevance of qualitative considerations contemplated in SEC Staff Accounting Bulletin (SAB) no. 99, *Materiality*, is a useful exercise, and in any event

will typically be required by external auditors at the completion of the investigation. It is also helpful to answer this question: How will the company's officers, employees or shareholders feel if the matter is fully exposed in press coverage?

If the allegation could potentially be material to the financial statements, the company's external auditor will likely rely on aspects of the investigation to complete its audit procedures. As a result, the auditor may perform other "shadow" procedures to gain comfort over the work performed, including, for example, interview debriefs, an assessment of the procedures for collecting or processing electronic files, and a completeness test of the e-mail review procedures.

STEP 4: CONSIDER EXPERTISE NECESSARY TO INVESTIGATE

Once the key attributes of the alleged misconduct have been assessed, it is important to determine if specialized knowledge of the company and its processes or procedures is required to conduct the investigation. For example, if the Chinese

EXECUTIVE SUMMARY

■ **A financial fraud allegation demands an appropriate and timely response.** The process includes knowing how to assess the allegation and selecting the appropriate investigative resources. Follow this process for determining how and by whom an allegation should be investigated:

■ **Identify implicated parties in the organization** who may have been involved or had knowledge of the alleged misconduct. Will investigating these individuals put internal resources in a position to review their peers, their direct reports or their direct/indirect supervisors? If so, the investigation may require the use of external resources.

■ **Consider the quality of preliminary information** and deter-

mine if the alleged misconduct is, in fact, improper under relevant laws, policies and procedures or if the allegation makes sense relative to the company's overall business practices, policies and procedures.

■ **Assess the quantitative and qualitative materiality of a possible fraud** to the greatest extent possible. Consider qualitative as well as quantitative considerations, including senior management's involvement.

■ **Determine if specialized knowledge of the company and its processes or procedures is required to conduct the investigation.** Internal resources may be considered objective in some circumstances,

but they may not possess the specialized investigative skills required. In addition, auditors and regulators might consider external resources more credible.

■ **Mind the logistics: language, resources and timing.** Identify resource needs and ensure that your proposed investigation team is able to dedicate sufficient resources to meet reporting deadlines.

■ **Consider the perspectives of other constituents** such as external auditors, litigators and regulators. Those relying on the conclusions of the investigation, such as external auditors, will want assurances that the investigators were objective and competent.

■ **Perform a cost-benefit**

analysis. External investigative resources will almost always be more expensive, but costly delays or rework, follow-up inquiries by auditors, and costs related to renegotiating loans or other financing may be reduced or avoided.

Greg Regan (regang@hemming.com) is a director in Hemming Morse Inc.'s Litigation and Forensic Consulting Services Group in San Francisco. *Kristin Rivera* (kristin.d.rivera@us.pwc.com) is a partner in PricewaterhouseCoopers LLP's Advisory practice in San Francisco.

To comment on this article or to suggest an idea for another article, contact *Loanna Overcash*, senior editor, at 919-402-4462 or lovercash@aicpa.org.

subsidiary operated a legacy or home-grown general ledger system, internal resources may bring a unique skill set that cannot be found elsewhere.

Alternatively, does the allegation require specialized investigative skills that internal resources are unlikely to possess? For example, an external forensic accountant may have had the opportunity to conduct investigations into stock option backdating at dozens of clients while the internal auditor will most likely only be faced with this issue once. Capitalizing on this expertise is perhaps the biggest benefit of leveraging external resources.

While internal resources may qualify as objective in some circumstances, external resources may garner more credibility with auditors or regulators and may be preferable as a result. Jason Flemmons, associate chief accountant of the SEC Division of Enforcement, however, tells us that he is more flexible in his view: “In assessing the quality and reliability of an internal investigation’s findings, the staff applies the same criteria irrespective of whether the investigation was performed internally or by an outside third party. In particular, the staff evaluates the scope of the investigation, the thoroughness of the procedures performed, and the competence and objectivity of those involved in the undertaking.”

STEP 5: MIND THE LOGISTICS: LANGUAGE, RESOURCES AND TIMING

It is important to be mindful of logistical issues such as where the investigation will take place and whether the company has sufficient resources to conduct the necessary procedures. Michael Warner, senior director of internal audit at NetApp, explains how he staffs investigations: “When deciding whether to deploy internal audit resources or to retain outside forensic resources to conduct an investigation, I consider whether the issue is likely to be material to the financial statements as well as the complexity and sensitivity of the allegation under investigation. I also consider whether my internal audit team has the bandwidth and requisite language skills to

perform the work within the required time frame” (see sidebar, “Internal Audit as Investigators: Impact on Morale”).

Often, companies will be focused on regulatory requirements and filing deadlines. External auditors will generally require the investigation of an allegation that has the potential to be material to be completed before the financial statements are issued. The decision makers will need to evaluate the importance of conducting the investigation in this time frame and whether it can be done to the satisfaction of the auditors using internal resources. Companies may look to outside forensic accountants for their ability to assemble large, scalable teams on short notice, thereby increasing the likelihood that key deadlines will be met.

STEP 6: CONSIDER THE PERSPECTIVES OF OTHER CONSTITUENTS

It is not uncommon for constituents such as external auditors, litigators and regulators to be skeptical of a company’s decision to use in-house resources to conduct an investigation. According to Joseph Fonti, a partner at the law firm Labaton Sucharow LLP in New York, specializing in representing institutional investors in securities fraud litigation: “If the issue is likely to be the subject of future litigation, an external investigative resource may serve to curb an outsider’s skepticism that any favorable outcomes of an investigation were foregone conclusions at their outset. The same may not be true with an internal audit resource.”

Companies may worry that the work of internal resources may not be subject to attorney-client privilege and as a result, could be subject to disclosure in litigation. As a result, it is usually advisable to seek legal counsel to determine whether legal privilege may be extended to the investigative resources.

Accordingly, those relying on the conclusions of the investigation, such as external auditors, will want assurance that the investigators, irrespective of their disposition, were objective. Furthermore, ➤

the company and its external auditors will need to be satisfied that investigative personnel have the appropriate knowledge and technical skills to carry out the required procedures.

As part of this evaluation, it is often relevant to consider the prior related experience of external resources, including any exposure to regulators. It is also useful if the investigative resources have had external audit experience or are affiliated with firms that conduct financial statement audits as either will likely provide insight into the mind of the auditor. If it is applicable, decision makers will need to consider whether internal personnel have the ability to identify errors or oversights in their own prior testing; for example, if internal audit had recently completed side-letter testing at the Chinese subsidiary, and the allegation is premised on this same issue. And, in some instances, external auditors may be inclined to perform more intensive procedures when the investigation is conducted by internal resources.

STEP 7: PERFORM A COST-BENEFIT ANALYSIS

Cost is clearly an issue when considering internal vs. external resources, and external investigative resources will almost always be more costly—at least in terms of immediate cash outlay. However, the use of external resources may result in ancillary cost savings by avoiding costly delays

or rework, decreasing follow-up inquiries by auditors, and reducing costs related to renegotiating loans or other financing.

In balancing these considerations, it might be possible to get the best of both worlds by pairing internal and external resources to conduct a joint investigation. For example, in the case of the alleged revenue fraud in China, a company may elect to send its internal audit director to lead the investigation in China, assisted by local external-based forensic accountants. Alternatively, the company may retain an experienced forensic accountant to design the procedures and to oversee the detail of the work performed by the company's internal audit staff.

CONCLUSION

“There are distinct benefits to leveraging either internal or external resources (or a combination of both) to conduct the investigation,” said Bob Pommer, a partner at the law firm Kirkland & Ellis LLP in Washington and a former SEC Division of Enforcement attorney who advises companies in responding to such situations. “In selecting the appropriate investigative team, a company must be mindful of the potential unintended consequences of the decision down the road,” he said.

One thing is certain—no two matters are exactly alike and there are myriad ways to configure an investigative team. Ultimately, the key to distinguishing the

benefits of internal or external investigators may come down to the nature of the alleged misconduct and the individuals at risk of implication. ❖

Additional information about options for staffing an investigation are available with the online version of this article on journalofaccountancy.com. Enter 20091574 in the search box.



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Internal Audit as Investigators: Impact on Morale

In some instances, it can be beneficial to position external resources as the “bad guy,” especially to conduct sensitive investigative procedures involving key personnel. Because most investigations are confidential, when employees learn of terminations or other remedial actions emanating from an internal investigation, they may assume that management or internal audit's actions were vindictive. In these situations, an internal audit department can quickly become known more as an internal affairs department. This can impair the openness of future dialogue between the internal audit team and the rest of the company's employees, with long-term consequences for corporate culture and controls.

In this sense, external advisers often conveniently play the role of “scapegoat” following an investigation. Management can attribute the remedial actions to recommendations of external advisers and thereby transfer resulting ill will from management to the outside investigators.