

The audit committee's evolving role in overseeing special investigations

The challenging government enforcement environment

In recent years, the local regulators have increasingly targeted listed companies, as well as their executives and directors, in enforcement efforts. As an example, Thomas Atkinson (Head of Enforcement Division of the Securities and Futures Commission ("SFC")), has highlighted listed companies-related issues as one of the top enforcement priorities. In a speech delivered in November 2016, Mr Atkinson said "We are particularly concerned about risks posed by corporate fraud and misfeasance.....key cases of this nature have wiped out more than \$200 billion in market capitalization from the Hong Kong stock market.....these cases not only caused immense losses to investors, they also severely damaged the integrity and reputation of the Hong Kong markets."¹

This environment has naturally prompted boards to prioritize special investigations of corporate fraud and misfeasance in an effort to address problems before they become the subject of regulatory enforcement.

When it comes to regulatory enforcement actions, the following two areas of focus are of particular interest to audit committee members:

- ▶ **Corporate fraud and misfeasance.** In the latest issue of *Enforcement Reporter* published in December 2016, SFC not only echoed Mr Atkinson's earlier speech, in addition it highlighted 6 notable enforcement priorities and that various specialized teams were set up to focus on those key risk areas. The top priority being a specialized team formed to focus on listed company-related fraud and misfeasance respectively as they pose one of the greatest threats to investors.²
- ▶ **Individual liability.** Enforcement actions will also focus on holding individual wrongdoers accountable for their misconduct. SFC quoted in the latest issue of *Enforcement Reporter* that "we have broad powers under the SFO to hold directors and individuals involved in the management of companies responsible for the misconduct committed by the companies they manage, and will vigorously exercise these powers where appropriate....Over the past three years, we initiated proceedings against over 50 directors and senior executives of listed companies for misconduct, breach of directors' duties and reckless or negligent conduct that contributed to their company's failings."³

We believe that part of this focus includes the scrutiny of gatekeepers, including board directors. While we do not frequently see the regulators prosecute audit committee members, there have been a recent exception. As pointed out by another regulator, Andrew Ceresney, director of the Division of Enforcement at the U.S. Securities and Exchange Commission, "The takeaway is straightforward: when an audit committee member learns of information suggesting that company filings are materially inaccurate, it is critical that he or she take concrete steps to learn all relevant facts and cease annual and quarterly filings until he or she is satisfied with the accuracy of future filings."⁴

Other trends that have led boards to pay greater attention to investigative issues is the prevalence of whistleblower claims reported either to the persons in charge of corporate governance within the organization or to the regulators, negative reports published by research analysts or short-sellers, or even issues exposed in the event of shareholder disputes.

Given all these background, the stakes have never been higher for audit committee members overseeing a special investigation. Furthermore, as several recent cases have illustrated, a flawed investigation can actually make matters worse for the corporation, while creating reputational and legal risks for the directors themselves.

It can be argued that a committee of part-time board members selected for their general business and financial acumen is neither designed nor equipped to undertake such a frequent and intense investigatory role. Reality, nevertheless, dictates that audit committee members understand how they will be judged when deciding whether to commence an investigation, how it should be conducted, who should be involved, how and when findings should be reported, and what, if any, remedial actions should be taken.

1. From the speech of Mr Thomas Atkinson at 7th Pan Asian Regulatory Summit, 9 November 2016
2. Issue No. 1 December 2016, *Enforcement Reporter* published by the SFC
3. Issue No. 1 December 2016, *Enforcement Reporter* published by the SFC
4. Andrew Ceresney, "Directors Forum 2016 Keynote Address."

Deciding whether to launch an investigation

Understandably, it would be challenging for directors, including independent non-executive directors, to determine which allegations, sourced from whistleblower hotline calls, government inquiries, press reports, internal audit findings, and elsewhere, should prompt the board to initiate an investigation. The few scenarios highlighted below would normally warrant a need to launch an investigation:

- ▶ **Financial irregularities.** Allegations relating to the company's financials almost always trigger an independent investigation by the board. These might include, improper accounting for business activities (for example, manipulation of earnings), or falsified books and records.
- ▶ **Allegations against senior management.** When the allegations involve the senior level of the organization, it is incumbent upon the board to oversee the investigation.
- ▶ **Regulatory matters.** Allegations that could result in a significant government enforcement inquiry often lead the board to conduct an investigation. As an example, investigations into allegations of bribery or money laundering by relevant authorities, would be an area that requires board-level oversight of an investigation.

Determining who to lead the investigation

Once the decision to go forward with an investigation is made, directors must decide what committee of the board should lead the investigation, whether the investigation will require outside counsel and/or forensic accountants, and how outside counsel and/or forensic accountants should be chosen.

Based on the specific facts and circumstances of the allegation, the audit committee may serve as the investigative sponsor or choose to delegate the responsibility:-

- ▶ Investigation may be delegated to a special committee of the board or to an investigative team which may include senior management, internal audit and in-house legal counsel.
- ▶ The audit committee must be aware that an investigation handled by the internal audit team without legal oversight and direction is subject to no legal privilege against disclosure and can actually create evidence damning to the company's interests.
- ▶ If the allegation involves senior management, manipulation of financial performance or criminal allegation, then it is more likely that the investigative sponsor should commission an outside counsel and/or a forensic accountant to be the investigation team. The selection of outside counsel is more fully discussed in the following section.

Electing to hire outside counsel

Investigative sponsor or the audit committee should bear in mind that the regulators may be looking for a gatekeeper, the ones who are charged with the responsibilities of corporate governance, to punish. As a result, audit committee members have to be very careful about how to handle investigations.

As a general rule, an outside counsel should conduct or, at a minimum, supervise the investigation on behalf of the audit committee so that the communications and work product generated during the investigation could be protected by applicable evidentiary privileges.

Moreover, audit committee investigations often require analysis of whether the law has been violated and the course of action that should be pursued to correct any violation and minimize potential liability for the company. This type of analysis is inherently legal in nature and is, therefore, best suited to experienced attorneys with the assistance of relevant experts in accounting, finance, and other disciplines applicable to the specific inquiry.

Determining whether to select in-house or outside counsel to conduct the investigation is a more nuanced question, as is determining whether to use the company's regular outside counsel or a firm with no substantial prior relationships with the company or its management.

The use of in-house counsel provides some obvious advantages, because the investigators are more familiar with the company's operations and likely will be less expensive and disruptive to the company. Use of the company's regular outside counsel can present similar advantages.

The use of in-house counsel, however, also has significant disadvantages. In-house counsel is more likely to be (and be perceived as) less independent of company management. Circumstances can create conflicts of interest for in-house counsel, particularly where the allegations of wrongdoing implicate senior company management to whom the in-house lawyers report. Similar issues are present when using the company's regular outside counsel with strong ties to management and a perceived desire to receive a continuing flow of work.

On the other hand, outside counsel with no material ties to the company is likely to be more independent of management, and their analysis will be perceived as more objective by regulators or prosecutors.

Independent outside counsel will also likely have greater expertise and resources available than counsel who do not specialize in conducting internal investigations. Most important, experienced outside counsel may have already established credibility with the regulators or prosecutors from their conduct of prior investigations or through similar work experiences.

Retention of forensic and other consultants

Investigations often go beyond legal issues and counsel almost invariably will require expert assistance in order to preserve, obtain and understand the evidence uncovered in an investigation. The outside counsel leading the investigation should retain any such expert, for example a forensic accountant or technology specialist, directly to bring the expert's work within the umbrella protections of the attorney-client privilege.

Most audit committee investigations involve some accounting or financial component. Accordingly, investigative counsel will commonly retain accountants to provide assistance during the course of the investigation. Forensic accountants are trained and certified in investigative skills, the collection and evaluation of evidence and the communication of findings to interested parties such as law enforcement, regulators or juries.

Avoid the desire to minimize or provide comfort

At the outset of an investigation, there is a natural desire to provide comfort and assurance to the market and other stakeholders that there has been no illegal conduct and that the matters in question will not result in significant adverse effects to the company. Making such statements before all the facts are known is problematic. Unfounded assurances can lead regulators or courts to believe that the company is not undertaking a serious and open-minded self-investigatory effort. Such statements can also result in the need for subsequent corrective disclosure as additional facts come to light. Finally, they can seriously damage the credibility of the company, its board of directors and management should subsequent findings prove otherwise.

Therefore, in most situations where an announcement is required, the best course of action is to simply announce that the matter is under investigation, the corporation is taking it seriously and the investigation will be independent.

Managing an Investigation

Inevitably, there may be a number of challenges that the board and audit committee must confront once an investigation formally begins. These included managing the scope of the investigation and communicating with other board directors, members of management, and the external auditor.

Managing the scope

When it comes to the investigation scope, there should be a balance between breadth and cost effectiveness of the investigation to properly address the allegations. On one hand, the scope should not be narrowly defined so that it would be subject to challenge by either internal or external stakeholders. On the other hand, how to maintain cost effectiveness and ensure that money is well spent with good value to the shareholders are also key. Seeking advice from and maintaining dialogues with the outside counsel and/or forensic accountants when determining the investigation scope are important.

The scope determination would be an iterative process as new information unfolds during the course of investigation. The scope will change as the facts change, and scope expansion is a natural question to be encountered by audit committee. Again, outside counsel and/or forensic accountants would be a valuable resource to provide insight and the right dialogues with the audit committee.

Communicating with management and the board

The importance of good communication as the investigation progresses extends beyond the circle of immediate participants. Audit committee leading the investigation would inevitably encounter requests from other internal stakeholders on the progress.

- ▶ **Other board members.** Generally, the sharing of information regarding the investigation with the board of directors and management should be on a "need to know basis" in order to preserve the applicable evidentiary protections. The audit committee should be cognizant of the possibility that any information provided to the board of directors may subsequently be subject to judicially compelled disclosure in subsequent legal proceedings.
- ▶ **Senior management.** Curtailing the information shared with management is also important to prevent inadvertent disclosure to the public or to management personnel who may subsequently be found to be implicated in the alleged misconduct. Accordingly, limiting disclosures to management regarding the investigation, except for that necessary to further the investigation, is generally the best course of conduct.

Maintaining relations with the external auditor

The company's external auditors are a very important constituency that must be managed with transparency and integrity throughout the investigation. The auditors will be keenly interested in the timing, thoroughness and conclusions of the investigation, especially if it involves allegations of wrongdoing by those members of management who make representations to the auditors.

External auditors will frequently engage their own forensic accountants and data specialists to assist the audit team in its assessment of the investigation. This forensic team will "shadow" the audit committee's investigation and advise the audit team whether it was conducted in a thorough, independent and effective manner in order to assist the auditors in determining whether the investigative findings are worthy of reliance.

It is usually helpful for the audit committee to communicate with the external auditors about the scope of the investigation and who will perform it at an early stage. While the auditors are not in a position to approve the company's choice of counsel or forensic accountants, early communication will provide the opportunity for the auditors to provide input and to flush out whether the auditor's perception of the competency or objectiveness of the audit committee's preliminary choice would make it more likely that the auditors will accept the findings of the investigation.

Likewise, it is often beneficial for the audit committee to communicate the initial scope of the investigation to the external audit team as soon as possible.

Furthermore, to the extent the scope of the investigation changes as new information is discovered, these changes should be timely communicated to the audit team. This type of ongoing communication can go far in building credibility for the investigation with the external auditors.

The investigative team will often need to provide the external auditors with information about its work plan and progress in order to satisfy the audit firm's shadow investigation team. In some cases, it can be important to frequently discuss the progress of the investigation with both the audit and shadow investigation teams.

Disclosing to shareholders and the general public

Another issue that companies must face as an investigation unfolds is whether and when to disclose information about the investigation to shareholders and the general public.

The audit committee will often find that it is called upon to direct important disclosure decisions with imperfect and incomplete information. In addition, during the conduct of an internal investigation, the investigators' understanding of the facts often evolves as additional evidence is uncovered. The company must therefore continually reassess its disclosure obligations, and the audit committee should consult its outside counsel to decide the timing and nature of any public disclosures that are advisable as the facts unfold. The audit committee should bear in mind that there would be reputation risks specifically for directors if disclosures are inadequate.

A relevant point to note here - from the latest issue of *Enforcement Reporter*, one of the tips from the SFC for market players is that the SFC values timely, open and transparent disclosure of misconduct.⁵

Deciding when to stop

While establishing and communicating clear objectives at the beginning of an investigation can facilitate the process of bringing it to a close, it may still be difficult to determine exactly when the investigation is complete.

Maintaining a thorough approach to examine all the relevant allegations is key to protecting the reputation of the audit committee. There may be certain limitations or dead ends as the investigation progresses, but the outside counsel and/or forensic accountants would be able to advise the possible and practical investigative means to deploy so that the audit committee can take those into considerations before bringing the investigation to a close, and to ensure that the audit committee would not be subject to criticism later.

On the other hand, completion of an investigation is unlikely to be the end of the matter. The audit committee is often involved in the follow-up activities that take place at the company in the wake of an investigation. Based on the findings of the investigation, there would be internal control or other remediation actions to be undertaken by the company to prevent occurrence of similar incidents going forward. Audit committee is often requested to oversee the implementation of the remediation efforts, ensure proper resources to be put into implementation and monitor the progress of the remediation plan.

Conclusion

Overseeing an audit committee investigation is complex, intense and time-consuming. Making the right choices at the outset and along the way is critical to obtaining a good outcome and to ensure that the audit committee properly discharges its legal and fiduciary duties, and mitigate their reputation risks.

5. Issue No. 1 December 2016, *Enforcement Reporter* published by the SFC

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