



Conducting Internal Investigations

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Overview of Fraud and Recent Trends

What is fraud?

Fraud is generally described as

- an intentional or deliberate act
- to deprive another of property or money
- by deception or other unfair means

Types of fraud

- Against the company
 - Internal: illegal acts of employees, managers and executives against the company
 - External: illegal acts of outsiders (non-employees) against a company
- For the company
 - Where the fraud benefits the company without direct link to personal benefit i.e. earnings manipulation

Why some organizations could be vulnerable

Environmental

- Operating in an industry with many failures or instances of fraud
- Losing market share and struggling to meet analysts estimates
- Experiencing financial difficulties and diminishing cash flow

Internal factors

- Decentralized structure with numerous remote locations
- The company might be dominated by few at the top
- Management compensation linked to short term results
- High employee turnover rate, particularly in the legal/finance/accounting function
- Employees are poorly paid, have low morale and are overworked

Internal control

- Poor accounting records
- Un-empowered, Internal Audit function
- Lack of focus and training on compliance and ethical behavior

Trends increasing risk and potential impact

Both personal and company pressure are on the rise

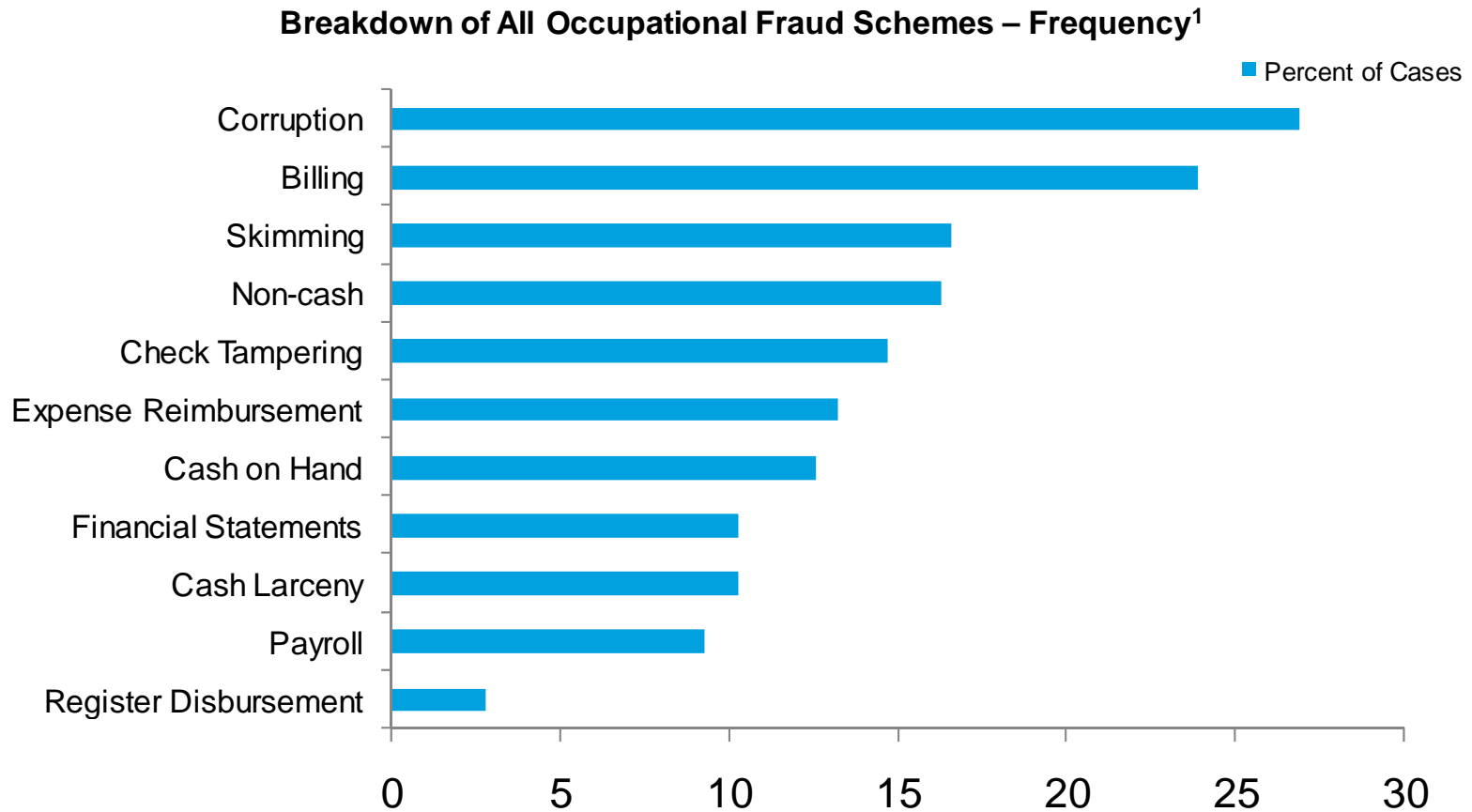
- Personal
 - Personal financial need increasing
 - Desire to increase personal financial wealth as protection/status
 - There may be a perception of increased opportunity
- Corporate
 - Limited availability of cash and capital funding
 - Pressure to meet earnings targets/analyst expectations
 - Stock price declines
 - Business units struggling to meet or exceed financial targets
 - Headcount reductions
 - Scarce employee resources are deployed elsewhere
 - Potential for loss of segregation of duties
 - Fewer resources to deal with an increase in issues and reportable concerns

External audit expectations

- Increasing emphasis on fraud



Most common fraud types - 2008



¹The sum of percentages in this chart exceeds 100 percent because several cases involved multiple schemes from more than one category.

Source: 2008 ACFE Report to the Nation on Occupational Fraud and Abuse

Determine Whether an Internal
Investigation is Necessary

Factors to consider

Nature of the allegation

- Implication of senior management
- Implication of non-compliance with laws or regulations
- Asset misappropriation / fraudulent financial reporting

Source of the allegation

- Whistleblower hotline
- Direct/Indirect Knowledge

Impact of the allegation

- Impact to financial statements
- Probability of fraud allegation being disclosed to the public

Factors to consider

Duty of Care

- Business Judgment Doctrine

Section 10A Investigations

- External auditor requirements

Section 307 of Sarbanes-Oxley rules

- Company counsel requirements

Self Regulatory Organizations

- NYSE affirmative duties

Exercises

Should an internal investigation commence based on the following fictional scenarios?

Company receives allegation from customer that fraudulent disbursements may be occurring through over-billing schemes

Company receives allegation through whistleblower hotline that inflated revenue is being recorded for less creditworthy customers

HR receives letter from IT manager that unusual journal entries are being posted after the close of the period

A/P Manager receives tip that the Chief Operating Officer is making personal purchases on the corporate card

Company receives allegation from A/P clerk that purchasing team is receiving free services from vendors

Determine Investigative Scope

Determining the investigative scope and team

Each investigation should be approached on a case-by-case basis, considering:

- Seriousness of allegation
- Risk to company if allegation is proven to be true or represents “tip of the iceberg”
- Credibility of the source of the allegation
- Resource allocation
- Investigation expertise
- Cost of investigation
- Need to demonstrate independence or obtain attorney-client privilege



Involving the Audit Committee

The Audit Committee (or some special committee of independent directors) should assume control of the investigation if allegations involve

- Accounting or financial reporting where there is more than a remote possibility they could be material to the financial statements
- Involvement of a member of senior management
- Possible material impact on the way the company is viewed (potential for broad public awareness)
- Actions could invoke regulatory attention

Audit (Special) Committee has an responsibility to answer at least five critical questions

- Was an effective and complete investigation performed?
- Did wrongful conduct occur (and if so, to what extent and effect) ?
- Have all reasonable steps been taken to address the effects of the company's wrongful conduct?
- What assurances does the board have that similar misconduct will not recur?
- Should the matter be reported to regulatory authorities or disclosed in filings?

Dealing with External Auditors

External Auditor will be an active and interested participant in the investigation

- SAS 99, “Consideration of Fraud in a Financial Statement Audit”
- SAS 54, “Illegal Acts”
- Securities Exchange Act of 1934, Section 10A
- SAB 99 and SAB 108, “Materiality”
- SAS 107, “Audit Risk and Materiality in Conducting an Audit”
- SOX § 404, § 806, Whistleblower Protection
- PCAOB Auditing Standard No. 2, “An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements”
- SAS 85, “Management Representations”

Shadow (or “parallel”) investigations common

Exercises

Determine the scope of the investigation and possible need of external resources

Company receives allegation through whistleblower hotline that inflated revenue is being recorded for less creditworthy customers

Company receives allegation from A/P clerk that purchasing team is receiving free services from vendors

A/P Manager receives tip that the Chief Operating Officer is making personal purchases on the corporate card

Several Critical Steps in the First Phase of the Investigation

Critical steps of an internal investigation

- Investigative planning
- Document collection and analysis
- Interviews
- Report Writing
- Remediation



Investigative Planning

Conduct with the right focus and procedures to answer:

- What happened and during what time period?
- Who was involved?
- Why and how it happened?
- What was the impact?

Perform the investigation as efficiently (cost and time) as possible

Suggest potential remedial actions

Respond to interested parties (external auditors, SEC, etc.)

Investigative Planning

Strategic planning

Tactical planning

Investigative constraints

Investigative information sources

Investigative requirements

Document Collection and Analysis

Understand and evaluate probative value of evidence

- Know your investigation
- Importance of information obtained
- Relevancy of information obtained
- What does information mean

Document Collection and Analysis

Public record information can make a case!

- Internet and subscriber database

Electronic Communications

- Emails
- Computer drives
- Voicemail and instant messenger files
- PDAs

Document Analysis

Financial records and source documents

- Invoices
- Cancelled checks and requests
- Ledgers and journals
- Payroll records

Financial statements

Document Analysis

Transaction Tests

- Financial criminals usually leave a trail
- Trail starts with financial records and source documents
- Detailed and thorough review necessary
- Invoices: Most non-compliance schemes start with false invoices
- Checks: Information on checks can tell the real story
- Payroll: False payroll is a simple and easy way to divert large sums of money

Document Analysis

Confirmation

- Transactions will be disguised and concealed
- All records should be suspect
- Third party confirmation to pierce disguise

Interviews

Interview Preparation

- What are you going to accomplish?
- Interviewing plan, knowledge and documentation
- Who are you interviewing
 - Fact Witness
 - Hostile Witness
 - Subject or Target
- Understand the best and worst result
 - Know the answers to your questions
- What are your limits and authorities

Interviews

Control

- Obtain information you need
- Use appropriate questions
- English
- Do not give answers
- Stay on topic

Interviews

Control Interviewing Techniques

- Develop a style – “Be Yourself”
- Organized, focused and dress
- Good listening skills
- Practice poker
- Control and confrontation

Interviews

Detail

- Conduct interviews to obtain sufficient detail
- Do not accept incomplete or unresponsive answers
- Ask all questions necessary for required information

Interviews

Corroboration

- Always corroborate facts obtained by interviews
- Use all sources of information and investigative techniques

Next steps of the internal investigation

- Financial statement and internal control remediation
- Report of findings



Common issues when conducting investigations

Inappropriate or insufficient first steps

- Lack of focus in the investigation
- Evidence destruction
- Electronic data disappears
- Excessive/inadequate scope
- Not understanding the needs (e.g., scope, nature and timing of assignment) of the company

Too fast

- Rushing to reach conclusions for a filing
- Lack of consideration to important factors (e.g. independence, privilege, preservation of documents etc.)

Trying to do too much in-house

- Lack of experienced investigators involved
- Conducting parallel investigations internally
- Not involving outside assistance early enough
- Not notifying external auditors early enough

Communications

- Ineffectively communicating with counsel
- Inadvertently influencing/limiting the auditors
- Not maintaining good relations with the external audit firm

Questions?

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