

THE CHALLENGES OF FORENSIC ACCOUNTANT AN EXPERT WITNESS

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Forensic accountants' and fraud examiners' work product is always subject to criticism and is well-anticipated in our adversarial legal system. What basic reasons can lead to the rejection of the evidence of experts? The author has tried to discuss situations that might make expert testimony subject to criticisms, how to keep your work product free from flaws and how to write and defend your report as a Forensic Accountant.

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Introduction

While Fraud Investigators and Forensic Accountants may be the crucial cog in bringing suspects to justice, they may not necessarily be called in to the court as expert witnesses to testify their findings. This happens because there are certain criteria that need to be met for courts to determine if a particular forensic Accountant is needed and qualified as an expert.

Nonetheless, for the purpose of article, it has been assumed that a person who is in the field of forensic accounting or fraud examination is sufficiently qualified to be accepted by the court as an expert.

This write up is motivated by the need for fraud examiners and other accounting experts who are involved in an investigation to understand how courts view their findings. This may allow them to corroborate evidences and present their findings in a convincing manner accordingly. The professionals in this field always have to walk the fine line of balance between two separate entities: being independent as demanded by the court as well as being impartial from the parties that have engaged them. Any fatal error, or major flaw in the investigation could not only spoil their career as an expert, but it may also have a serious blow on the credibility of the profession if the court frequently renders such expert evidence as inadmissible. An expert may either be testifying or non-testifying depending on the situation. If he or she is a non-testifying expert, the opinion may be used throughout the case such as for the evaluation of the case; to assist in planning a strategy, search, obtain, examine, and evaluate evidences; interview witnesses; explain developments in the case; assist pre-trial motions, pleadings, and responses; and take notes and conduct investigation during the trial. If they are testifying experts, in order to maintain independence and objectivity, they should not get involved in pretrial motions and responses. The expert should not be present during the trial or cross-examination of various respondents and

witnesses.

More often than not, the investigation ends up in court and the need for an expert testimony arises. The investigator is then requested to testify based on their finding and go through the process of cross-examination. When the investigator appears in court to testify, he or she goes through real acid test and a lot of stress in the witness box. Not only are investigators required to answer the questions posed by cross-examiners, they are expected to convincingly explain themselves. This needs a careful and thorough preparation.

Overview of the Current Scenario

In Asia, we are still far behind in the race to control and eliminate the elements of fraud, corruption, and manipulation. The lack of formal education in fraud, forensic accounting, and financial criminology has resulted in the scarcity of such professionals and experts who can convincingly testify in the court. This problem has further been aggravated by the notion that no special skill or training is needed to deal with the alleged fraud. Unfortunately a number of young accountants (CAs, CPAs, and CFEs) who have entered into the field of investigation and forensic accounting assume that the use of audit techniques is sufficient to investigate financial crime/occupational fraud without realizing the legal aspects, law of evidence, jurisprudence and rules governing a particular jurisdiction. All these factors play significant roles in establishing a fact. Forensic audit or investigation needs rigorous attention to details and precision to deal with the situation and to reach a conclusion that can stand at its own during the storm of cross-examination. There is no room for chance and as such, each and every possibility needs to be examined to create a body of evidence whose components are mutually reinforcing to infer the guilt of the accused. In my opinion, this is probably the single most important factor that can make the investigation fundamentally flawed if not dealt with the utmost attention.

This problem appears to be universal in nature. PwC in the United States conducted an interesting study from 2000 to 2007 titled “Examination of Daubert Challenges to Financial Expert Witness” that indicated how many financial experts’ testimony did not satisfy the standards of relevance and reliability under Daubert.¹

In 1993, the U.S. Supreme Court’s opinion in *Daubert vs. Merrell Dow Pharmaceuticals* was as follows: “I’ve addressed the admissibility of expert scientific testimony in federal trials popularly

¹ 2000–2007 Financial expert witness Daubert challenge study
www.pwc.com/en_US/us/forensic-services/assets/2000_2007_daubert_study.pdf

known as ‘Daubert test’ to determine the reliability and relevance of the testimony.” Although this historical judgment was initially for expert scientific testimony, in 1999 the Supreme Court’s (USA) decision in *Kunoho Tire Co vs. Carmichael* clarified that the Daubert criteria were applicable to all types of expert testimony and not just the scientific ones.²

This study identified lack of reliability in the work of financial experts as a key influencer in successful exclusion of financial experts. In 2007 alone, three out of four exclusions of financial expert testimony were attributable to the unreliability of the experts’ work.

During a period between 2000 and 2007, this study identified 3,681 Daubert challenges to experts out of which 635 were targeted to financial expert witnesses. Out of those that were challenged, 47 percent of the expert witnesses were either excluded or their testimonies partially excluded. In 2007, 41 percent of all challenges to financial experts were successful at excluding the expert’s testimony either in whole or in part.

I do not have published data or a study indicating the situation in the South East Asia but based on feedback from various lawyers, CFEs, and other accounting experts, there are certain cases where testimonies of accounting experts were excluded and this is certainly an issue in Asia Pacific as well. I have tried to summarize issues involved in following paragraphs.

Methodologies to Meet Expectation of the Judge

Once a report is prepared, an expert can give sworn evidence in the form of sworn affidavits and as a witness under direct examination and cross-examination during court hearings. In order to make their work credible, high ethical standards and an independent approach must be followed and the work must get the basic truth to reflect objective views. Well prepared, objective, clear, and well corroborated presentation significantly draws the judge’s attention and accordingly affects the outcome of the trial.

Needless to say, the expert’s objective should be to help the court to understand the evidence and to determine the fact that is in dispute rather than highlighting the point of his client. It is therefore necessary that financial information is translated into simple, effective, and clear testimony so that a judge can readily understand the findings. To make the report credible and persuasive, logical

² *Kunoho Tire Co vs. Carmichael*
www.law.cornell.edu/supct/html/97-1709.ZS.html

analysis of various scenarios in a given set of circumstances is necessary. In civil cases, it is very important that circumstantial evidence not only be consistent with the guilt of the accused but also inconsistent with any other reasonable explanation as mentioned above.

It is well founded that investigators need to be detail oriented; however, while performing an investigation, the expert should not disregard the bigger picture. By not looking at the big picture, the expert is likely to be blindsided during cross-examination because all the plausible alternative explanations or scenarios have not been considered.

For example, during an investigation into the loss of aluminum stock, the investigator took the weight of each cast aluminum part that was produced and as determined by the client based on standard average weight. However, this calculation of average weight of each part was flawed because there was a small child part (made of steel) inside the cast aluminum part. Although the weight of the child part was only 5 percent of the weight of the cast aluminum part, the forensic accountant's testimony was questioned because of the error in the findings. Hence, such pitfalls due to tunnel vision must be avoided. In reaching a conclusion, the forensic accountant must test all the possible hypotheses that can arise out of the circumstances of the case and the issues involved. This will reduce the possibility of their findings and conclusions being challenged because they had taken into consideration all the possibilities. For example in an aluminum die-cast factory, the excess consumption of aluminum might be attributed to following reasons where some lapses were observed while testing the efficacy of internal control and risk associated with those lapses:

- Raw materials purchased did not reach the factory but were debited to purchases.
- Raw materials were received, goods were produced, but semi-finished goods that were sent outside for secondary processing have not been returned in full or properly accounted for (during the review of internal control in place and its effectiveness it was observed that regular reconciliation of goods sent to outsiders for processing and received back after processing was not available).Raw material has been rejected after production and sent outside to smelters for re-melting and full quantity has not been received.
- Goods sent outside for processing or re-melting were higher in quantity/weight than recorded as there were no quantitative records of defective goods produced and sent for melting.

- Dross or wastage declared was higher than actual or, while sending dross outside, aluminum was also sent.
- Finished goods have been shipped out to local customer, cash has been collected outside, but sales were not recorded.

These may be the various possibilities in a situation where certain lapses pertaining to recording and handlings of material were observed. It is the investigator who has to test all these hypotheses individually with an in-depth understanding of the industry to reach to a valid conclusion. The purpose of this exercise is to confirm why only a particular method has been used by the suspect as *modus operandi*. It is very common for the defense to work out a theory completely opposite to what has been concluded by the plaintiff in order to confuse the court.

The moment it appears to the court that the defense's contentions are plausible, the expert's testimony is weakened and the purpose of engaging an expert is defeated. As an investigator, one must consider all the evidence, not just those that suit the objective of their client.

It is advisable to ask a colleague independent of the assignment to review and challenge the conclusion. As mentioned before, the opposing lawyer will always be on the lookout for any opportunity to discredit the technique, testimony, and fact-finding skills of the accounting expert. As such, the experts should never be conservative in their imagination; they must consider and test all the possible hypotheses to reach their conclusion.

In an interesting case, an employee was alleged to have siphoned a huge amount of money from his firm by using pre-signed cheques left by one of the signatories. The firm had a policy that any cheque issued for \$5,000 and above would require two signatories. Since one of the signatories used to travel frequently, he had signed blank cheques in advance to be used in his absence by the other signatory. The accused employee was the custodian of the pre-signed cheques.

When the case was heard in court, the accused employee claimed that the allegedly siphoned transfers were done with the consent of one of the signatories who had deliberately asked him to deposit the cheques into the accused employee's accounts and to debit the amounts to various expense/creditors' accounts with the objective of increasing expenses to reduce taxable profit. This transferred money was then returned by the accused employee to that particular partner in cash for personal use. The fraud examiner had failed to consider and investigate this hypothesis during his investigation and during cross-examination could not convincingly explain that such an

arrangement was not possible. The lawyer for the firm also failed to convince the judge that the hypothesis put forward by the employee was not possible since this aspect was never examined and investigated by the expert. Unfortunately, evidence was also adduced in court by the defendant that the firm had indeed booked false purchases through nonexistent creditors, which made the situation worse for the plaintiff. The defense took advantage of this lapse in the investigation to get the culprit off the hook. Hence, it is common in the adversarial process of law for the opposing counsel to try tooth and nail to suggest alternatives to expert's findings.

Opposition Tactics and Ways to Win

An investigation needs to have a multidimensional approach to make it complete from all angles and for it to pass the acid test. In order to achieve this, the forensic accountant (FA) must always critically review their own findings and think how their findings might be challenged.

There are certain prerequisites which can help an investigator to develop hypotheses which are logical and consistent with the situation that allowed the fraud to take place:

1. The FA must have complete understanding of the internal control of the business entity where he or she is conducting the investigation.
2. Test the effectiveness of internal control process to understand how comprehensive it is and how people at all levels throughout a company are involved, including those who keep accounting records, prepare and disseminate policies, and monitor systems.
3. Identify the accounting cycles that have been affected due to the alleged fraud.
4. Identify various phases of the cycle that ultimately results in recording a transaction.
5. Look for source documents and other evidence generated by each phase of the identified cycles.

Once the weaknesses in the internal control system have been identified, the next step should be developing and testing hypotheses as mention above.

In my given example, to ascertain the first proposed hypothesis (dummy purchases of aluminum), one needs to focus on purchase cycle and other factors such as:

- Annual consumption pattern for the last 3–4 years
- Level of inventory of last the 3–4 years
- Ratio between purchase of raw material and sales figure for last 3–4 years

- Average price of raw material in last 3–4 years
- Raw material consumed vs. sales ratio (3–4 years)

The above information may help the investigator to develop a parameter and benchmarking to identify anomalies pertaining to consumption and to ascertain at a very early stage of investigation whether prima facie there is a case of alleged manipulation of raw material consumption.

By adopting a systematic and structured approach, an investigator can easily avoid certain pitfalls and tie the loose ends to avoid any embarrassment during cross-examination.

Any expert witness who deals with numbers, valuations, discounts, and so on must be able to clearly and articulately explain where the numbers come from. Many of these experts are, unfortunately, unable to properly explain this during cross-examination.

Knowledge of the Business

As mentioned before, in any assignment where the application of forensic and investigative skills is involved, it is important for the forensic accountants to have a good understanding of the client's business operations and market environment to conceptualize the true meaning of the accounting records and data in front of them.

A basic knowledge of the business's many facets—the operation of the industry, the various phases of the accounting cycle (production cycle, revenue cycle, payroll cycle and procurement cycle), the major customers, the suppliers, the competitors—is of paramount importance. This basic information is needed to develop a benchmark and to identify abnormalities.

In an interesting real-life case in Selangor, Malaysia, a high-rise construction crane accidentally came apart and fell down on an aluminum die-cast factory causing damage to its die-cast unit, the retaining factory wall, and the roof of the factory. As a result of the accident, three of the six high-pressure die-cast machines were out of service for six months and, as a direct consequence, the machine operators and their assistants were laid off and eventually replaced by a new team of workers. The factory's accounts department made an estimate of the losses, which amounted to approximately \$650,000. After an in-depth review by a forensic accountant, the estimation of loss suffered by the plaintiff was re-calculated and it amounted between \$1.3 and 1.5 million. The disparity in the loss estimations by the accounts department and the forensic accountant was attributed to the following:

- ❑ The loss estimation worked out by the accounts department only represented the cost of replacement/repair of the machines, bricks and mortar, and loss of profit on production.
- ❑ A major component omitted from the account department's damage quantification was the "learning curve" cost of the new die-cast operators who were hired after operations restarted. During the initial learning curve period, productivity was 50 percent lower compared to the production output of previous team of operators and there was also an exceptionally large amount of scrap and defective goods that required reprocessing and approximately 260 operating hours were lost.

As evident from this case, even departments within the company may not know how the many facets of the operation are interrelated. Investigators must therefore have strong knowledge of their client's business.

Independence Is a Crucial Factor

Experts provide opinion evidence and should therefore only testify to what they have observed or someone has told them. If there is lack of independence by an expert, the court might be misled by him or her. Furthermore, when an expert is selected by the client on the advice of his lawyer, the lawyer's integrity and reputation is also at stake. An expert who asks, "What do you want me to say?" can't be good to anyone and is not suitable for either party. Lawyers must consider the expert's academic qualification, area of expertise, and ability to assist during the trial and understand complex issues involved in the case.

Some of the experts who specialize in fraud investigation might not have developed the skills needed for damage quantification or valuation of an ongoing business.

Possibilities can't be denied that an expert who has worked with defense or plaintiff or for both and has never been tested by the courts system might need to prepare to appear in the court as an expert. This generally happens because some claims are settled prior to the commencement of the litigation due to various reasons and only a few cases face the challenge of cross-examination. Before accepting any assignment, an expert must evaluate whether the work involved matches his expertise and experience.

I have read couple of court cases in which the judge was very critical of expert witnesses because of their tone of advocacy for their client. Expert accountants should avoid the temptation to resist everything said by opponents' lawyer to maintain their credibility.

Precautions While Writing Reports

Generally, in civil cases, the lawyer will furnish a written report of the expert engaged by them or their client to the opposing party. The Malaysian rules of civil procedure do not require an expert's report in writing, save for certain statutes (e.g., Land Acquisition Act 1960), where a written report of the values must be submitted.

Once such a report is furnished, the confidentiality related to it is waived and the report is accepted as evidence. Following this, oral evidence will be given by the expert. The expert who has prepared the report must stand by the facts and opinions expressed in it. The process emphasizes the importance of the expert report and the utmost care that the expert must take in preparing the report.

When the report relates to fraud investigation, it should include all the pertinent facts, uncovering the “who”, “what”, “where”, “when”, “why”, and “how” of the fraud.

While writing a report, the investigative accountant must be careful to avoid using an accusatory tone. Accusations and making conclusions about the guilt of the suspect being investigated can be damaging to the investigator because the final power to convict rests with the judge and not the investigator. Even if the suspect has confessed the wrongdoing or embezzlement and the management has taken disciplinary action against the suspect, the forensic accountant in their report must still refrain from passing judgment and maintain neutrality. Subjective and prejudicial language may reflect that the forensic accountant has compromised his objectivity, is biased, and might have distorted the facts while preparing his report to make his point. Instead of an accusatory language, if the findings support the allegation, the language of the report could be: “the investigation confirmed the existence of reasonable credible evidence to support the allegation against Mr. X and the suspicions are tenable.”

Conflict of Interest

One must understand clearly that business of public accounting must be apart from the business of investigation. There is a serious issue of conflict and various national accounting bodies should come out with code of ethics and regulations so that unsuspecting clients' vulnerability to hire incompetent and negligent practitioners can be minimized.

Further, accountants should not get involved in the investigation for assurance clients. At the initial stage it may not be the intention of the client to sue the suspect employee for the recovery of embezzled fund but there is nothing that can prevent a change of mind. In that case the work of an auditor who has also served as assurance auditor faces a serious challenge posed by issue of conflict of interest. There might not be an apparent issue of conflict at the time of the assignment but during the course of investigation if it becomes an issue, consult with legal counsel for most appropriate action.

Conclusion

FAs fully understand the exact sequence of events and the basic truth by using their expertise, time, and resources. A report that is well researched, carefully reasoned, written in a manner that is easily understood and presented effectively will help the judge to understand the complex issue and, in so doing, create a good impression on the judge. I believe now is the time for accounting bodies around the world to regulate this profession by setting standards to uphold the quality of this profession.