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FORENSIC ACCOUNTING – NEW RULES AND OPPORTUNITIES

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The Hon. Michael Kirby AC CMG

CHARTERED ACCOUNTANTS

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PRESENT WHEN THE TIDE RUNS OUT

Forensic accounting is a comparatively new specialty within the old and distinguished world of accounting. Of course, there has always been a role for professional accountants in litigation of various kinds. Particularly so in contested taxation cases and in claims for damages, brought by companies or individuals, who needed to rely on accountants to demonstrate the likely losses or defaults occasioned by a breach of statute or a civil wrong.

Still, the role of forensic accountants has enlarged in recent decades because of a number of factors. One is the far greater ease with which fraud can be perpetrated in the digitised world. As Allan Watt has explained it[1]:

> "The main difference between [the 1930s] and our own time is that digitisation of the cash flow in a business has made it easier to move money from one place to another with a few clicks of the

* Justice of the High Court of Australia (1996-2009); President of the Institute of Arbitrators & Mediators Australia (2009-10); Board Member, Australian Centre for International Commercial Arbitration (2010-); Member, Arbitration Panel, International Committee for Settlement of Investment Disputes (World Bank) (2010-).

1 Allan Watt, "Digital Crumbs Show the Trail", *National Accountant* (April/May 2010), 25.

> mouse. From behind a computer screen or another electronic device, many users feel a sense of anonymity. Communication is faceless, indiscretions can be swept under the rug and onto a USB thumb-drive, documents are easily deleted and data can be stored in hidden folders or sent between private email addresses."

The expression "white collar criminal" was devised by Professor Edwin Sutherland in the years immediately following the Great Depression on the 1930s. The recent global financial crisis 2008-10 (GFC), which has caused profound economic changes in most western countries[2], has also seen an escalation in instances of intra-corporate wrongdoing to accompany the "climate of redundancies, pay freezes and pay cuts". Ironically, it has been the GFC that both stimulated internal misconduct and ensured the exposure of wrongdoing "at a burgeoning and unprecedented rate"[3]. It was the investment guru Warren Buffett who declared[4]:

> "It's only when the tide runs out that you learn who's been swimming naked."

A fraud investigation partner with KPMG Forensic in London, Hitesh Patel, observed recently that: "The tide [of the GFC] is still making its way out". He expects more wrongdoers to be exposed before the world economies fully recover. The type of fraudulent activity detected by Mr. Patel involves not only wrongdoing by individuals, but also by businesses themselves, as they came under growing financial pressure. As he put it: "Company bosses falsely inflate sagging profits and less-senior executives inflate their sales figures to keep much needed bonuses". Australian experts in forensic accounting also describe the

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[2] M.D. Kirby, "Welcome to the Real World" [the GFC] (2009) 32 *University of New South Wales Law Journal* 338.

[3] M. Laurence, "Fraud Capture. Forensic Accounting Experts Expect Already Record Corporate Fraud Levels to Rise as the Economic Downturn Continues to Bite", *Intheblack*, July 2009, 22.

[4] *Ibid*, 22.

way that the GFC had "lifted the lid on an orgy of fraudulent conduct". At once, the GFC can be seen as "exposing existing frauds but [also] ignite[ing] an outbreak of new activity"[5].

If this strong language seems to smack of journalistic excess, one has only to remember the astonishing case of Bernie Madoff who admitted to what was the biggest case of fraud uncovered following the GFC. It involved deception of investors amounting to almost $US65 billion. Madoff used money entrusted to him for investing to pay regular "returns" from the capital of new investors. It was only when he could no longer attract new investments, by reason of the GFC, that his complicated web of deception was revealed.

At the same time, unauthorised trading activity by a derivatives trader with Société Génerale in Paris, Gerome Kerviel, cost the bank the equivalent of almost £GB5 billion. Kerviel claimed that he was driven not by a desire for private profits, but by the "orgasmic pleasure" he derived from occasional astronomical profits that he made, before the pack of cards collapsed[6]. The Madoff and Kerviel cases (and many others) demonstrate beyond doubt that fraud and misuse of a trusted internal position is a global phenomenon today. It involves hugely increased sums compared to earlier times. It can happen at a far greater speed than when book ledgers were maintained in copperplate. Overwhelmingly it involves the technology of informatics.

The consequence of these developments is not only to impose huge pressures on policing agencies and corporate regulators. It has also led,

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5 *Ibid*, 23.

6 *Ibid*, 23.

inevitably, to pressure for internal control systems; improved auditing; enhanced professional accounting standards; and far greater public awareness of the scope, potential and seriousness of the challenge.

Courts in which I participated in Australia over 35 years, labour mightily to deal justly, and in accordance with law, with the comparatively trivial wrongs of theft and minor larceny. But now there is a significant new challenge that requires intelligent new responses. This is where forensic accounting comes in. To adapt the prognostications of academics who observe, and participate in, the development of forensic accounting, the field is growing exponentially. To say the least, it looks like an attractive employment option for young accountants today, looking for exciting new challenges likely to provide secure high remuneration into the foreseeable future[7].

Some developments are happening that amount to positive phenomena, likely to strengthen the profession of forensic accounting. One of these is the new regulatory environment. Thus, a revised professional standard on forensic accounting services has tightened the requirements of those who may practise in the field, although doubts have been expressed that some members of the profession do not understand how they may be affected by such changes[8]. The revised standard APS215, from the Accounting Professional and Ethical Standards Board, replaces APS11, *Statement of Forensic Accounting Standards* and G2, *Forensic Accounting*, both of which date back to July 2002. The new standard shows just how far forensic accounting has changed in a relatively few

[7] C. Davis, S. Ogilby and R. Farrell, "Survival of the Analytically Fit: The DNA of an Effective Forensic Accountant", *Journal of Accountancy* (August 2010), 54.

[8] Quoting Colin Parker in Jan McCallum, "Forensic Investigation", *National Accountant* (February/March 2010) 15 at 16.

years. And how guidelines on best practice have been adopted and are now compulsory. These guidelines are addressed to requiring independence in expert witness reports and application of the more stringent standards to accountants working in the corporate sector and in government, as well as in private practice. This tightening up of professional regulation must be welcomed as a timely move to enhance applicable professional standards at the precise time that greater demands are being placed on forensic accountants in Australia[9].

Yet, in the real world, several countervailing developments are occurring. These include:

* An estimated drop in prosecutions or professional disciplinary proceedings following the uncovering of internal instances of fraud. One commentator has suggested that, whereas a decade ago, 70% of such cases led to public proceedings, usually in court, now only about 20-30% of such cases take that course. This decline is attributed to a disinclination of organisations to prosecute because of reputational concerns. And the desire to "get on with business". This is often a short-term view that finds some parallels in the tendency of courts to be 'more understanding' of white collar than of blue collar crime. Perhaps this occurs because most judges can imagine a dinner party with a white collar criminal who may be otherwise a 'good chap'. A 'blue collar' criminal may be seen as just a member of the criminal classes[10];

[9] *Ibid*, 16 referring to a comment of Steven Ponsonby, MPW Fraser.

[10] See also L.E. Heitger and D.L. Heitger, "Incorporating Forensic Accounting and Litigation Advisory Services into the Classroom", 23 *Issues in Accounting Education* 561 (2008).

- A second reason for the inadequate response is the lack of funding of law enforcement and regulatory agencies which means that they are often unable to act before the trail has gone cold;

- A third consideration, mentioned by Professor Colin Ferguson, Professor of Business Information Systems at the University of Melbourne, is the need to understand how funds from corporate wrongdoings can now be easily transferred internationally. And how complex accounting systems can be set up in sophisticated ways to disguise even the most audacious internal conduct[11];

- A fourth suggested obstacle to action is the pressure that can arise during economic downturns involving the downsizing of middle management which is often the very level that serves as the "eyes and ears" of a company in the detection of wrongdoing by those higher up or lower down[12];

- And a fifth possible consideration is the expansion of corporate dealings into new and different environments in the developing world of the planet, where bribery and kickbacks are more prevalent. Even where this is illegal, including under Australian law, it can erode the culture of corporate integrity whilst at the same time affording convenient avenues for masking corporate misconduct[13].

To challenge the inertias that accompany such development, forensic accountants require legal and institutional support, such as the

[11] Quoting Professor Colin Ferguson, in McCallum, above n8, 16.
[12] KPMG Forensic's Hitesh Patel quoted *Intheblack*, July 2009, 22 at 24.
[13] Laurence, ibid, 24.

introduction of whistleblower systems so that those who are suspicious of wrongdoing can have a safe avenue for reporting their suspicions and securing prompt data analysis to search for anomalies[14]. Additionally, it will often be crucial, where suspicions are raised, to give immediate access and control over systems to forensic accountants able to isolate voluminous electronic files so as to prevent them being deleted by the wrongdoers or contaminated by puzzled, disbelieving, amateur investigators[15]. Allan Watt puts it this way[16]:

> "If the electronic money trail could talk, it would tell you to leave the electronic device alone in any situation where you suspect a fraud has been committed. This does not mean 'do not investigate', it means 'do not contaminate'.
>
> The moment a device is turned on, hundreds of files are modified. Applying a forensic methodology when investigating ensures the available data has been collected and mitigates the risk of compromising the evidence. If the evidence is required before a court, a forensic approach will ensure the evidence is afforded its full weight."

Fortunately, there is one other development that generally operates to the advantage of skilled forensic accountants. I refer to the collection in numerous external systems of detailed, and ultimately retrievable, trails of individual conduct that will subsequently provide objective and provable evidence that permits a course of wrongdoing to be reconstructed, pieced together and understood by reference to impeccable third party sources. Allan Watt described this development in this way[17]:

> "While there are now more opportunities for fraud, it is also much easier to discover who was involved and how it happened. The

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14 Gary Gill quoted in McCallum, above n8, 16.
15 A. Watt, above n1, 25.
16 *Loc cit*.
17 *Ibid*, 25.

> digitisation of not only the corporate environment but day-to-day life means that we inadvertently leave behind data 'crumbs' that can be used to trace our electronic movements.
>
> This happens when you wake up in the morning and hit the stop button on your personal mobile which has a convenient but annoying alarm clock. While eating breakfast you turn on Foxtel and watch the news. Leaving the house, you enter your code into the alarm and this is relayed to the monitoring station. On the way to work, you stop for petrol and pay for it through EFTPOS. Your e-tag is captured at two toll collection points. Meanwhile, your NavMan records your route. Arriving at the office, you use your keycard to gain access to the car park. You reach your office, gaining entry with your ID, and send a text message on the company-supplied Blackberry. You log in to your computer, check your emails, surf the net and complete some internet banking. It is only 9am but there are at least 23 electronic records of your movement from home to work and across the internet.
>
> A computer or 'e-forensic' expert is able to put together a story from these data crumbs. An e-forensic's case will involve a structured investigation into electronic devices that potentially store relevant evidence. These devices may include computers, mobile phones, PDAs, laptops, network servers, USB hard-drives, digital cameras, MP3 players, and so on."

In the struggle between apathy, embarrassment, empathy for wrongdoers who are old friends and the expense of the investigation, the capacity of skilled forensic accounting to uncover, pinpoint and bring home wrongdoing to those responsible can generally prevail. At least it can do so if the costs involved and the other downside elements of the investigation are worth the outcome that it may produce. That outcome must always retain a commonsense approach but remember that the offender who gets away with wrongdoing once will often be tempted to return and even enter a bigger league.

The corporation is one of the great inventions of the Anglo-American legal system. It divorces the capacity of the entrepreneur to take risks from the shareholders who fund the risk-taking, but on terms that they will have limited liability in the event that the risk-taking fails[18].

The success of our form of economy depends very heavily on the integrity of corporate governance. This is why statute, common law and professional practice so heavily invest in principles designed to establish the rules and institute the procedures to uphold integrity. It is why wrongdoing on the part of individual officers and employees of corporations has a corrosive effect if it ever becomes so widespread and unrepaired as to undermine the culture of integrity upon which corporations rely.

In some ways, corporate integrity is similar to the integrity in the judicial office. Australia is one of the comparatively small number of nations in the world where judicial integrity is deeply entrenched in our culture. It is strongly upheld by professional and legal values. It is assumed by all players. It is deeply shocking when departures from judicial integrity come to light. Such departures, whether in the judiciary or in corporations, have an importance beyond the individual case. In the case of corporate officers and employees, this does not mean that every instance of wrongdoing must be tracked down ruthlessly whatever the cost, however long it takes and however great the resources expended in doing so. The marginal utility of detection must be greater than the marginal cost of the forensic investigations. But in doing those sums, it is essential to keep in mind the element of cost involved by allowing

[18] Paul Johnson, *Making the Market: Victorian Origins of Corporate Capitalism*, Cambridge Uni Press, 2010, 103ff.

unrepaired wrongs to be ignored. It is because forensic accounting plays such an important and growing role in helping in the detection, demonstration and proof of misconduct in individual and corporate life that it is so important to society as a whole. Its importance transcends, the individual cases in which forensic accounting is deployed.

PUZZLES AND CASES

A. The five rules on expert opinions

Consideration within the courts of the special features of the evidence of forensic accounting is a relatively recent phenomenon. In the magnificent service published by Dr. Ian Freckleton and Mr. Hugh Selby, *Expert Evidence* (Lawbook, Sydney, 1993), produced in four large volumes, it was not until they reached the fourth volume, nearing the end of their exploration, that the authors offered a part (Part 123) dealing with "forensic accounting". The part was written by Mr. Geoffrey A. Cohen and Mr. Mark B. Bryant. Properly, and predictably, the part describes "forensic accounting" as "the application of accounting principles and generally accepted practices to facts or hypotheses at issue in a legal dispute"[19]. The authors correctly point out that, whatever the popular assumptions, forensic accountants are by no means confined to unearthing fraud in corporations. The range of proceedings in which their skills are needed is enormous. It is almost as varied as the many aspects of the litigation process, or indeed of the legal relevance of accounting expertise.

Amongst the particular field in which forensic accounting had, to that time, been deployed in Australia, the authors list:

[19] I. Freckleton and H. Selby, *Expert Evidence* (1993), Lawbook, Sydney, 123.50.

- Commercial contract claims for breach of contract terms or repudiation of a contract;
- Intellectual property cases such as *Paragon Shoes Pty Ltd v Paragini Distributors (NSW)*[20] for "passing off" particular shoe styles;
- Merger and acquisition disputes;
- Trade practice infringements;
- Loss of income or earning potential arising from accidents or conditions of the workplace;
- Product liability claims for defective products;
- Environmental claims, such as clean up necessities;
- Insurance claims relating to a failure to indemnify or meet losses found to be covered by policies;
- Ledger liability claims for breach of a contract to lend or invest funds;
- Taxation claims relating to compliance with taxation law;
- Construction claims; and
- Family law disputes involving business valuations and property settlements.

The engagement of forensic accounting extends to every potential aspect of the foregoing proceedings. It involves assisting those engaged in trial preparation; helping lawyers to prepare for cross-examination of opponents' witnesses and experts; offering expert testimony on a matter in contest in the litigation; identifying documents that need to be procured by discovery, subpoena or made the subject of

[20] (1998) 13 IPR 323.

questioning; assisting in settlement negotiations; or serving as an arbitrator, mediator, referee or independent expert.

In their study, the authors trace the successive stages of the forensic process to explain the role that forensic accountants can play in procedures of fact-finding, scrutiny of evidence, report preparation, trial conduct and settlement negotiations. An important section of the study concerns the quantification of damages and the variable hypotheses that need to be taken into account in calculating damages by reference to identified possibilities.

Because forensic accounting is but one specialised aspect of expert testimony more generally, it is made clear, and is the fact, that forensic accounting is subject, like all other suggested fields of specialised knowledge, to general rules that control the giving of expert evidence before a court or tribunal: whether constituted by a judicial officer, a jury or statutory tribunal. The tendered evidence has to comply with five basic rules:

1. *The expertise rule*: So that the propounded witness is permitted to express an opinion by reference to an accepted field of knowledge or expertise in which he or she has recognised credentials;

2. *The common knowledge rule*: Which forbids a witness, purporting to give expert evidence, from pretending to do so but actually providing to the decision-maker what, on proper analysis, is nothing more than common knowledge about which the decision-maker is perfectly competent to reach conclusions of his own without having to rely on a so-called expert;

3. *The area expertise rule*: By which the witness, having established credentials in a particular field, is confined to expressing opinions that fall squarely within that field of expertise and do not stray into other fields of expertise or of knowledge outside the established credentials;

4. *The ultimate issue rule*: By which the expert is forbidden from usurping the role of the decision-maker and expressing, in the form of an expert opinion, a conclusion on the ultimate issue which is reserved to the tribunal of fact. This rule emphasises the subordinate and facultative role of the expert, which is to assist the decision-maker with special opinions, not to take over the decision-maker's functions; and

5. *The basis of evidence rule*: By which the expert must confine his or her testimony so that it addresses a clearly established basis in fact for the expression of the relevant opinion. An opinion cannot be expressed at large. It has to be clearly based on hypotheses that are sufficiently identified. This is so because the expert opinion is ultimately only as good as the facts upon which it is based. If, in the course of the hearing, those facts are not established, the expert's opinion is knocked away. It has no legitimacy. In fact, it should not be received into evidence. If already received, it should be discarded as unsustained by the evidence in the case.

These rules are straightforward and logical. Because of differences in the law of evidence in Australia, their detail will vary from one jurisdiction

to another. But the basic rules have arisen in many cases in which I participated, or which I have seen over the years. Time allows me only to mention one or two relevant instances.

B. The basis rule and forensic accounting

The courts in New South Wales have, in the last year, considered a particular aspect of the 'basis rule'. The matter arose before Justice Garling in *Hudson v Howes & Ors*[21], a decision of December 2010. In that case, the Supreme Court of New South Wales had ordered that there should be a joint conference of experts who had been retained by the opposing parties to express opinions on issues that related to the quantum of the liability sued for in the proceedings. The object of the conference was to minimise the areas of disagreement between the experts; to enable the production of a joint expert report identifying any areas of agreement and disagreement; and to enable the concurrent evidence of the experts to proceed in an orderly and efficient manner.

Directions were given by the Court that the parties confer in order to agree on the assumptions that the experts would be asked to make for the purpose of expressing their opinion. Unfortunately, the parties did not succeed in a number of attempts to agree on such matters. This was why the case came before Justice Garling to give further directions.

The litigation concerned a claim by a qualified horse trainer, working at the Moruya Race Track in January 2004. Whilst working in a mounting enclosure, he was kicked by a horse and was seriously injured. He sued the defendant claiming that he knew, or ought to have known, that the horse had a disposition which led it to misbehave violently and to kick

[21] [2010] NSWSC 1503.

out with its hind legs. Upon that premise, he argued that they should have warned him and protected him.

The plaintiff relied on the expert opinion of a retired horse trainer and riding instructor. She had been provided with all the documents upon which to form and express her opinion. She had spoken to a number of people who had dealings with the horse in question. She gave her opinion based on a large number of factual assumptions, some only of which were clearly identified.

This was the course of conduct criticised by the defendants. They relied on a long series of court decisions that stressed the need to correlate the assumptions for expert opinion so that these could be tested against the facts eventually proved in the case. Specifically, they relied on what Chief Justice King had said in South Australia[22]:

> "The course which was sought to be adopted in the present case of asking the opinion of the witnesses of the possible mental condition of the accused at the time of the alleged crime, based not only upon assumed facts, but upon a reading of the whole of the evidence and the accused's account of his drug ingestion, is not acceptable and such evidence cannot be admissible. It involves the expert in making his own unstated findings of fact and his own interpretation of them."

A similar opinion had been expressed by Justice Heydon, now of the High Court of Australia, then in the New South Wales Court of Appeal, in *Makita (Australia) Pty Ltd v Sprowles*[23]:

> "If evidence tendered as expert opinion evidence is to be admissible, it must agreed or demonstrated that there is a field of 'specialised knowledge'; there must be an identified aspect of that field in which the witness demonstrates that by reason of specified

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22 *R v Fowler* (1985) 39 SASR 440 at 443.

23 (2001) 52 NSWLR 705 at 731 [85].

> training, study or experience, the witness has become an expert; the opinion proffered must be 'wholly or substantially based on the witness's expert knowledge'; so far as the opinion is based on facts 'observed' by the expert, they must be identified and admissibly proved by the expert, and so far as the opinion is based on 'assumed' or 'accepted' facts, they must be identified and proved in some other way; it must be established that the facts upon which the opinion is based form a proper foundation for it; that the opinion of an expert requires demonstration or examination of the scientific or other intellectual basis of the conclusions reached: that is, the expert's evidence must explain how the field of 'specialised knowledge' in which the expert is expert by reason of 'training, study or experience', and on which the opinion is 'wholly or substantially based', applied to the facts assumed or observed so as to produce the opinion propounded."

Justice Garling found that the expert propounded by the plaintiff in the case before him, had breached these rules. This could not be breached except in a simple, straightforward and uncomplicated case where the facts were admitted or readily identifiable[24]. At least, in a complicated case, where the facts were not readily identifiable, it was not possible to put the whole of the transcript and documentary evidence to the witness *en bloc*.

Obviously, this is a line of authority that must be carefully observed by forensic accountants in preparing any expert opinions they are asked to give. It is not always easy to observe the rule. A forensic accountant will generally be dealing with highly complex material and a vast range of information. It will be important, therefore, to sift this material and to ensure that the premises upon which the opinion is expressed are identified, listed and made known. Doing so may sometimes require dialogue between the expert and lawyers. This is because, without such dialogue, a lawyer (being outside the field of expertise) may not

[24] *Trade Practices Commission v Arnotts Ltd [No.5]* (1990) 21 FCR 324 at 330 per Beaumont J.

appreciate the significance of particular facts. But once having identified the pertinent facts upon which the opinion is stated, the foundation for the expert opinion will be clear. This will then afford the opinion a proper grounding in law. The admirably clear and succinct reasons of Justice Garling show the logic that lies behind the law's rules in this regard. It is a logic that applies in the range of cases involving forensic accounting expertise.

C. The believable witness?

Yet how is a judge, confronted by conflicting opinions of experts of great experience, such as highly talented forensic accountants, to choose between them and to select one as the opinion to be preferred? This is not a hypothetical or unimportant question. It is one that can determine the outcome of a case. It is therefore a question upon which judges themselves, lawyers, forensic accountants and ordinary citizens are entitled to have guidance from the appellate courts.

In my life as a barrister, the rule that was applied in appellate courts was that appellate courts would not disturb factual conclusions reached by a trial judge which the trial judge had either expressly or by necessary implication arrived at on the basis of his or her impression of the witness. This rule had judicial support dating back to the 19th century when the first appellate courts were established in England, at a time when the appeal process was unaccustomed to reviewing factual conclusions. In part, this was because most such factual conclusions, at that time, were made by juries and were substantially unexaminable. Juries could not be interrogated as to their reasons for reaching their conclusions. That is why judges had earlier simply accepted and applied their conclusions. When the procedure of appeal came about, the courts continued to

follow this course, although, with the increasing number of decisions of a factual kind made by judges, they often had a mixture of reasoning as well as their own intuition to explain the judges' conclusions.

Some judges in Australia who were raised like me in this traditional deference to factual conclusions of trial judges adhered to such opinions well into the 1990s. During that decade, three important decisions were delivered by the High Court of Australia in *Jones v Hyde*[25]; *Abalos v Australian Postal Commission*[26]; and *De Vries v Australian National Railways Commission*[27]. Those decisions laid down a rule that appellate courts should not disturb the conclusions of trial judges where they had been made with the advantage of seeing witnesses. This permitted trial decisions to be affirmed on appeal, even in instances where the overwhelming force of the evidence appeared to the appeal court to demonstrate that the trial judge had simply got the facts wrong, even seriously and obviously wrong.

In my experience of 25 years in appellate judging, I came to the conclusion that more mistakes were made at trials in Australia from misunderstanding and confusion about the *facts* that from *legal* mistakes. Yet until 2003, our courts generally deferred. Especially so where the judge specifically stated that his opinion had been influenced by the impression the judge had of the witness as a person who was telling the truth, or not telling the truth.

I was never myself convinced that this was a correct approach for the law to adopt. Scientific evidence came to my notice during my years of

[25] (1989) 63 ALJR 349 at 351-2.
[26] (1990) 171 CLR 167 at 177.
[27] (1993) 177 CLR 472 at 479.

service in the Australian Law Reform Commission, demonstrating that impressions of witnesses, including by judges, could be completely wrong. They could mask prejudices of various kinds, particularly where the witness came from an ethnic or other community different from that of the decision-maker. I made several attempts to get the High Court to change its position on this rule. The early attempts did not succeed[28].

Then, in 2003 in *Fox v Percy*[29], the majority of the High Court modified the old rule. The majority held that a finding of fact by a trial judge in Australia, based on the credibility of witnesses could be set aside, although only where there were "incontrovertible facts or uncontested testimony that demonstrated that the judge's conclusions were erroneous". The High Court went on to permit a further exception where the appeal court could conclude that the decision at the trial was "glaringly improbable or contrary to compelling inferences in the case".

These conclusions re-introduced a principle of logic and rationality into appellate judging. This is important for forensic accounting. It means that a conclusion on the evidence of forensic accountants will not be inpenetratable simply because a judge has seen the competing expert and other witnesses and preferred some over others. Even if the judge states that the evidence of one should be disbelieved because the judge is convinced that the expert is biased, partial or dishonest, that does not relieve the judge and any appellate court of examining the case by reference to the criteria in *Fox v Percy*.

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[28] *State Rail Authority (NSW) v Earthline Constructions Pty Ltd (In Liq)* (1999) 73 ALJR 306 at 327ff [87]-[93].

[29] (2003) 214 CLR 118.

Another decision in the Supreme Court of New South Wales last year should be noted in this connection, this time by Justice Michael Ball in *Orica Investments v McCartney*[30]. That was a case which concerned as assessment of damages referred to Justice Ball by order of Justice White who had found in favour of a claim of loss to a supplier of various essential lavender oils. The task in hand was to assess the damages. Different expert accounting and other opinions had been provided. Justice Ball had to choose between them.

There was no dispute that the appropriate method, in principle, of calculating the loss was that of using a discounted cash flow analysis, based on the respective financial records of the contesting parties. Justice White in the liability proceedings had found that one of the key witnesses was "not a reliable witness"[31]. Justice Ball reached the same conclusion, on the basis of that witness's testimony before him. However, doubtless because of the influence of *Fox v Percy*, Justice Ball did not leave it there as would have been done by many a trial judge in earlier times. He went on to give "three main reasons" for disregarding the evidence of the contested witness concerning what would probably have happened if there had been no breach of contract. The most important of those reasons was that "none of the contemporaneous records" record[ed] the reason for the termination of the arrangements given by the witness[32]. In other words, the judge went back to the contemporaneous email and documentary trail. He examined the details of the written records. He could find no contemporaneous evidence suggesting that the challenged witness had approached other distributors. Nor could he find evidence that this person had taken

30 [2010] NSWSC 488.
31 [2010] NSWSC 488 at [29].
32 *Ibid.*

reasonable steps to mitigate his company's loss. He accepted that the correct approach involved a robust calculation of compensation, relying on a presumption against wrongdoers that the onus of proof in doubtful questions ran against the party "whose actions have made an accurate determination so problematic"[33]. Nonetheless, he could not infer that it was likely that the arrangements between the parties would have broken down without the action taken by the wrongdoer.

Justice Ball then went on to explain why he preferred one expert's opinion over a suggestion by the other that the plaintiff company had overestimated the damage suffered. Once again, he gave full reasons as to why he did so. He analysed the competing expert opinions. He acknowledged the power of some of the opinions that ran against the decision that he ultimately preferred. But he explained why he accepted the plaintiff's expert. He acknowledged candidly that "there is no science in the determination of an appropriate discount". He looked into the detailed facts to see how the parties had conducted themselves at the breakdown of their relationship. From this he reasoned about the extent to which their respective testimony was supported by the contemporaneous documents.

This case is a very good illustration not only of the complexity of forensic accounting evidence and its often problematic and contestable character. It is also an illustration of the way in which judicial reasoning operates in Australia today. It is no longer based, in civil trials, on intuitive responses founded in the impression of witnesses. Nor is it now based on jury verdicts. It is based now (as in my opinion it should be) on

[33] Applying *Amory v Delamirie* (1722) 1 Stra 505; 93 ER 664, whose principle was explained by Handley JA for the Court of Appeal of NSW in *Houghton v Immer* (1997) 44 NSWLR 46 at 59.

the logic of the circumstances; by the trail left by correspondence and email records; by the believable testimony about contemporaneous conduct; and by the assessment of the entirety of the facts. This is a major change that has come about in the law in my lifetime. It is a change for the better.

THE LAW BENDING TO REALITY

Another great change that has occurred since I entered the law is the shift from litigation before independent judges and courts to mediation and arbitration before selected experts and neutral intermediaries. The growth of alternative dispute resolution (ADR) is already a large industry in Australia. For the most part it is beneficial, providing empowerment to parties in dispute because their competing contentions do not need to be mediated through advocates and lawyers. Now, increasing numbers of professionals gain accreditation in forms of alternative dispute resolution. I have myself done this. Mediation and arbitration allow a proper time for discussion and negotiation, which previously had generally to be squeezed into a tiny space allowed by the pressures of courtroom proceedings and deadlines.

The introduction of ADR has also encouraged a more hard-nosed attitude on the part of disputants to the role that dispute mechanisms play in loss distribution between the contesting parties. Take for example the allegations recently made by New York's Attorney-General against one of the world's largest firms of professional accountants, claiming that they had helped the failed financiers, Lehman Brothers, to disguise that firm's financial condition for more than seven years while collecting more than $US150 million in accounting fees. A law suit, brought by New York Attorney-General Andrew Cuomo, alleges that the

firms engaged in practices to erase temporarily as much as $US50 billion in Lehman liabilities. They contended that this occurred at the end of a quarter, allegedly making Lehman Brothers look more healthy than it was. They claim that an accounting manoeuvre, called 'repo105', was used to shift the assets out of Lehman's books in return for a promise to buy back the securities at a premium days later. Cash received by Lehman was then used to pay down other debts. Allegedly, the accounting firm "directly facilitated" an accounting "sleight of hand and burnished the securities firm's balance sheet", Mr. Cuomo claimed in the law suit[34].

News stories of the law suit describe how two of Lehman's chief financial officers were former employees of the accounting firm during much of the seven year period when the transactions allegedly occurred. Obviously, the relationship between Lehman Brothers and the accounting firm was highly profitable to the latter. It grew even more lucrative as Lehman Brothers' business boomed during the years when it used repo105 transactions. According to securities filings, in the decade before its demise, the accountants earned more than $US185 million in audit and other fees from Lehman. In the final 2007 year before Lehman's bankruptcy, it was the accounting firm's eighth biggest United States client in terms of audit fees. It was in the top 15 clients for the accountants during the previous seven years, according to data from auditanalytics.com.

Where huge losses occur, such as happened repeatedly during the GFC, the natural tendency of lawyers and other advisers is to seek ways

[34] "Fraud Claim – The Civil Law Fraud Suit Depicts A Cosy Relationship Between Two Firms", *Wall Street Journal* in *The Australian*, December 23, 2010, 23.

of distributing the losses. It does not take too much imagination to consider a spread of liability to auditors and other accounting and business advisers of a failed business, alleged to have failed in duties of independent scrutiny and disclosure. In such claims, the role of forensic accountants is critical to the proof before courts of the validity and quantum of the claims.

But there is more than this. No such claims today go directly to a court of law without prior consideration of ADR. ADR will only partly be addressed to the issue of what will occur if a trial proceeds to conclusion. It will also, invariably, be addressed to the risks of litigation; damage to reputations; the direct costs that must be accrued; the indirect costs of tying up staff for years perhaps decades in time-consuming and ultimately unproductive activity of litigation defence; and engaging in collateral claims searching for still more third parties to bring into the suit and ADR discussions. Thus, in a case such as the foregoing, professional indemnity insurance may well be engaged as may be other individuals and business advisers who are claimed to be responsible for some part of the huge losses at stake.

Of course, I do not comment on the Lehman Brothers case, which will be determined by the New York courts. But there are many similar but smaller, parallels in Australia. In all of them, forensic accounting is critical. It is critical not only for the gathering of evidence; for the identification of wrong-doing or neglect; and for the skill of forensic accountants to simplify, express and explain in testimony highly detailed chains of evidence. Equally important is the provision of reports that, today, are used in negotiations conducted under the aegis of skilled mediators or which are referred, by consent, to experienced arbitrators

whom the parties accept as decision-maker, in preference to the uncertainties of the judicial roster.

Whereas in a court of law, the resolution of claims and counter-claims ultimately involves the ascertainment of factual evidence and the application to it of identified principles of law, the bottom line in much ADR is economic: tolerable loss distribution and assessment. This has not reduced the role and importance of skilled forensic accountants. It has simply shifted the priorities (substantially to written reports) and the venues (out of courtrooms to private negotiation or arbitration). The essential talent remains the same: skill in identifying and establishing the relevant facts; talent in simplifying highly complex matters; and persuasiveness in expressing conclusions in a way that influences outcomes. But the end of the process will now often be quite different. Winner take all can be a very risky gamble.

If anything, the shift to ADR has enhanced the role of forensic accountants. In a news item that accompanied the *Wall Street Journal* report on the New York claim arising from the collapse of Lehman Brothers was an item recording that one of the largest German banks had agreed to pay $US553.6 million and admitted criminal wrongdoing to settle a long-running probe over fraudulent tax shelters that allowed clients to avoid paying billions of dollars in US taxes[35].

This “non- prosecution agreement” would obviously have arisen out of the most intensive and prolonged forensic accounting exercise carried out by the United States Attorney’s office in Manhattan and the Internal Revenue Service. Allegedly, the 15 tax shelters involved more than

[35] “$556m Paid for Tax Shelter Scam”, *Wall Street Journal* in *The Australian*, December 23, 2010, 23.

2,100 customers between 1996 and 2002, including shelters marketed by large and well reputed accounting firms, as well as the defunct law firm Jenkins & Gilchrist. According to the news report, customers used the transactions to generate more than $US29 billion in bogus tax benefits, mainly losses. The sum of $US553.6 million payment represents the total fees that the bank collected during the period, the taxes and interest the IRS was unable to collect during the period, and a civil penalty of more than $US149 million. One has only to mention these figures to imagine the delight of the forensic accountants who were given the challenge of unravelling, as they did, the modern thread of Ariadne that led the IRS to its discoveries, proof, claim and recovery.

None of this would have happened without huge investments of highly talented forensic accountants, deployed on both sides, leading to the negotiated settlement in the extremely large sums mentioned. In comparison to most matters litigated before Australian courts, contests of this kind present corporations with highly practical commercial decisions that need to be made. No such decisions can be made without the benefit of forensic accounting skills of a high order, deployed on both sides. It cannot be said that, economically, these skills constitute a waste of productive resources. The fact that the skills are available, and will be used, becomes a most important consideration in the commercial assessment of the corporate strategies that will work and those that will fail.

All of which demonstrates that the future of forensic accounting, in Australia and elsewhere, looks bright. The courts recognise this and have adopted sensible rules for the receipt of such expert testimony and for the evaluation of it where there is a contest. Still the talents of

forensic accountants in explaining such complex materials come at a high premium. And because they frequently concern very large, even huge, stakes, the work is very useful and necessarily lucrative[36].

In the past, a highly intelligent professional with an inquisitive mind, a curiosity to explore complex factual and regulatory puzzles and a talent in explaining them, would probably have opted for the life of a barrister. He or she would have contemplated the ultimate prospect of a judicial seat to warm the golden years of old age. Today, a young person with these skills would be well advised to consider the forensic accounting option. Of one thing we can be sure, forensic accounting is only likely to increase in importance and profitability. Unlike most commercial activity, work for forensic accountants actually increases during an economic downturn. Especially so when the tide runs out and reveals the detritus of wrongdoing to attract the eagles' eyes and a few unbeautiful naked swimmers.

From the law and ADR, I express respect and appreciation to forensic accountants. Once the wallflower in the theatre of litigation, your day has arrived.

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[36] C. Davis, R. Farrell and S. Ogilby, *Characteristics and Skills of the Forensic Accountant*, AICPA, FVS Section, 2010 identified the following chief skills: 1. Ability to simplify the information; 2. Ability to communicate orally; 3. Ability to understand the goals of the case; 4. Ability to identify key issues; 5. Ability to investigate intuitiveness; 6. Ability in written communication; 7. Ability to synthesise; 9. Flexibility and open-mindedness.