

## **Forensic Accountant: Reliability & admissibility as Expert Witness**

### **Forensic Accounting**

Forensic accounting is a rapidly growing area of accounting concerned with the detection and prevention of financial fraud and white-collar criminal activities. George A. Manning in his book "Financial Investigation and Forensic Accounting" defines Forensic Accounting as the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes. The integration of accounting, auditing, and investigative skills yields the specialty known as Forensic Accounting which focuses very closely on detecting or preventing accounting fraud. "Forensic", according to the Webster's Dictionary means, "Belonging to, used in or suitable to courts of judicature or to public discussion and debate." The word accounting is defined as "a system of recording and summarizing business and financial transactions and analyzing, verifying, and recording the results." The term 'forensic accounting' refers to financial fraud investigation which includes the analysis of accounting records to prove or disprove financial fraud and serving as an expert witness in Court to prove or disprove the same. Thus, basically, the forensic accounting is the use of accounting for legal purposes.

### **The History of Forensic Accounting**

The forensic accounting can be traced back as far as 1817 to Meyer v. Sefton, a Canadian case that allowed an 'expert witness' to testify in court. The term 'forensic accounting' was first published in an article in 1946 "Forensic Accounting- Its Place in Today's Economy" authored by Maurice E. Peloubet, a partner in Price Waterhouse. He stated that, "during the war both the public and industrial accountant have been and now engaged in the practice of forensic accounting". Many scholars have traced the roots of investigative accounting to his work. Interest in forensic accounting spread through the United States and England early in the twentieth century. One of the first institutions to use the services of such investigative accountants was the IRS. The story of Al Capone the famous mobster being caught on a tax evasion scheme is well-known. The FBI decided to use forensic accountants and employed nearly 500 such agents during World War II. As a profession, forensic accounting continued to grow during the latter half of the century, as GAAP and tax laws became widespread and mandatory.

### **The need for Forensic Accounting**

Forensic Accounting is a fast emerging field in the "World of Accounting". Although it has been around for a long time, it has become increasingly popular and much relevant today in view of global financial crisis due to the downfall of the Lehman Brothers and its ripples felt across the globe. Thus, a new avatar of Accountant has emerged known as Forensic Accountant. Although Investigative Accounting has been around for years, it has only recently begun to transform into a new branch of accounting, hence Forensic Accounting. Forensic accountants unlike traditional accountants, look beyond the numbers, put their nose and eye deep into the financial books, records and data to uncover fraud, hidden assets, siphoned funds and the like. The word forensic is defined as the application of scientific knowledge to legal problems and legal proceedings. The word accounting is defined as "a system of recording and summarizing business and financial transactions and analyzing, verifying, and recording the results." By combining these two definitions it can be concluded that forensic accounting utilizes his regular accounting principles & practices in legal situations. Forensic Accounting is like the bridge which connects accounting system to legal system. Thus, we can say that the forensic accounting is an

accounting that is used in a court of law. One of the most notable legal situations in the recent past would be the Enron scandals; where large numbers of American forensic accountants were employed. The wave of financial crisis primarily caused by corporate malfeasance and fraudulent financial activities eroded public trust and investor confidence in financial reports and audit services and need was felt to look beyond the conventional accounting function which only fulfilled the compliance requirements i.e. company's books of accounts are kept in accordance with rules & regulations. In view of the increasing number of financial frauds committed by conspiracy with complex accounting records manipulation, it was felt that a new tribe of Accountant is needed to detect the financial fraud in companies with his accounting, auditing, and investigative skills and also assist in legal matters. This area of accounting came to be known as 'forensic accounting'. There is a global awareness to fight the cases of financial frauds. Though many strategies have been formulated and many actions have been taking to fight against it, the problem still persists. One of the major hindrances in fighting financial crime cases is lack of quality forensic analysis of the financial statements and records due to lack of forensic accounting professionals. This author who had been an investigating officer during his tenure with Delhi Police in number of major cases of financial crimes have faced this dearth of quality forensic accounting experts who could have come handy in timely & accurate investigation of the intricate financial crimes and unearth the complex modus operandi adopted by the fraudsters who are themselves in some cases highly qualified financial professionals. The reason why there has been rampant increase in white collar financial crimes because they think that they can get away with it with impunity and the greatest deterrent to thwart the criminal act is law enforcement. However, the conviction rate in the financial fraud cases was very low due to weak law enforcement which is attributable to weak litigation support in prosecution process. Without full support of accounting expert, prosecutors often fail to prove and provide strong evidence to put fraudsters behind bar. Here, the Forensic accounting can play an important role here by providing accounting or financial information or other evidentiary inputs for legal purposes. To achieve the aim, forensic accountant besides having financial accounting expertise, should also have proven skill in law, scientific investigative technique, interpersonal and communication skills etc.

### [Growth of Forensic Accounting](#)

The Western Countries are utilizing the forensic accounting expertise to address the financial fraud cases. United States and Canada are pioneers in development & implementation of Forensic Accounting. The Canadian Institute of Chartered Accountant recently recognized Investigative and Forensic Accounting as an accounting specialty. The CICA has started granting its members to use the designation initials CA&#x2013;CIFA who complete three years post qualification experience as a CA with Diploma in Investigative and Forensic Accounting (DIFA) from the University of Toronto. The CA-designated specialist in investigative and forensic accounting (CA&#x2013;CIFA) combines the well-recognized and respected attributes of the CA – in particular integrity, understanding of business, and financial acumen – with an in-depth knowledge and experience in investigative and forensic accounting. The CA-designated specialist in investigative and forensic accounting (CA&#x2013;CIFA) combines the well-recognized and respected attributes of the CA – in particular integrity, understanding of business, and financial acumen – with an in-depth knowledge and experience in investigative and forensic accounting. This is accomplished through a profession-endorsed certification process that has ongoing experience and education requirements. The CA&#x2013;CIFA tells litigation lawyers, law enforcement professionals, the courts and other legal forums that the designated holder is well positioned to practise in areas such as fraud and economic loss quantification, including:

- investigating and analyzing financial evidence;

- testifying as an expert witness ;
- becoming involved in criminal investigations and uncovering financial evidence in employee or insurance fraud cases;
- Investigating in the rapidly evolving area of computer and Internet fraud.

### Forensic Accounting implementation in India

However in India, this branch of accounting has not got its due recognition even after alarming increase in the complex financial crimes and lack of adequately trained professionals to investigate and report on the complex financial crimes. The task of Forensic Accountants is handled by Chartered Accountants who apart from handling traditional practice of auditing as required under the Companies Act, 1956 or Income Tax Act are called upon by the law enforcement agencies or the companies or private individuals to assist in investigating the financial crime or scam. The CA or CWAs in India are best suited for this profession due to their financial acumen acquired during their rigorous training which can be further honed by introducing post qualification degree or diploma in Investigating and Forensic Accounting similar to one introduced by CICA. The CA or CWA who acquire post qualification in Investigative & Forensic Accounting can use the designation CA-IFA or CWA-IFA and be legally recognized as the Forensic Accounting Experts to handle the investigation of financial crimes and give expert testimony in the Court of Law. However, no efforts has so far been made by the ICAI and ICWAI, the two leading statutory accounting professional bodies to move in this direction and set up a institute which can offer the post qualification diploma in Investigative and Forensic Accounting to its members.

However, growing financial fraud cases, recent stock marker scams, failure of non financial banking companies, phenomena of vanishing companies and plantation companies and failure of the regulatory mechanism to curb it has forced the Government of India to form Serious Fraud Investigation Office (SFIO) under Ministry of Corporate Affairs which can be regarded the first step of Government of India to recognize the importance and advance the profession of forensic accountants. The SFIO is a multidisciplinary organization having experts from financial sector, capital market, accountancy, forensic audit, taxation, law, information technology, company law, customs and investigation. These experts have been taken from various organizations like banks, Securities & Exchange Board of India, Comptroller and Auditor General and concerned organizations and departments of the Government. However, the main important law enforcement agency involved directly in combating white-collar crimes is the Police, CBI, DRI etc. There is a total lack on the part of these law enforcement agencies to train their investigators in this specialized part of investigating white-collar crimes involving forensic accounting. The investigation of the major financial crimes is handled by ordinary investigating officers who after spending some time in investigation of conventional crimes are shunted to the economic offence wing and they are expected to handle the financial crime cases involving complex & intricate financial records which is required to be analyzed to unearth crime or unique MO adopted by the white collar criminal. The result is obvious, the case dies its natural death and the criminals roam free as the IO given his lack of specialized knowledge & qualification fails to properly investigate the financial crime to its logical conclusion. On the other hand if we look at the western countries particularly USA, the law enforcement agencies of which like DEA, FBI, CIA has well marshaled its pool of special agents having forensic accounting backgrounds that are the backbone of the bureau's financial crimes and terrorism financing units and investigate with professional acumen, the complex financial crime like money laundering, internet crimes, financial institution fraud and other economic crimes. Today, there are

more than 600 FBI agents with accounting backgrounds. Thus, it is highly imperative on the part of law enforcement agencies in India that they follow the suit and engage specialist forensic accountant on its roll whose engagements relating to criminal matters typically arise in the aftermath of financial fraud.

### **The Indian Law which refers to Forensic Accounting:**

#### 1) [The Companies Act, 1956:](#)

- a) Section 235 and 237: There are provisions [in Companies Act \(Section 235 and 237\)](#) which empowers the Central Government to inspect the books of accounts of a company, to direct special audit, to order investigation into the affairs of a company and to launch prosecution for violation of the Companies Act, 1956. Books of accounts and other documents of the companies are inspected by the officers of the Directorate of Inspection and Investigation and the Registrars of Companies. These inspections are designed to find out whether the companies conduct their affairs in accordance with the provisions of the Companies Act, 1956 to see whether any unfair practices prejudicial to the public interest are being resorted to by any company or a group of companies and to examine whether there is any mismanagement which may adversely affect any interest of the shareholders, creditors, employees and others. Wherever inspection reports disclose any information that may be of interest to other Departments or agencies like the Ministry of Commerce and Industry, Central Board of Direct Taxes, Enforcement Directorate, State Government or Provident Fund Authorities, such information is passed on to them. If an inspection discloses a prima facie case of fraud or cheating, action is initiated under provisions of the Companies Act, 1956 or the same is referred to the Central Bureau of Investigation.
- b) Provisions of Sick Industrial Companies Act incorporated into [the Companies Act, 1956: The Section 424A\(5\) of the Companies Act, 1956](#) empowers National Company Law Tribunal (NCLT) to examine as preliminary issue whether the company is a sick industrial company u/s 2(46AA). Thus even before examining the viability of the scheme of revival proposed by the company, NCLT can check the genuineness of the reference made to it. Thus, inquiry by operating agency will only be to enable NCLT to decide the viability of the scheme and to assess whether the company has the ability to revive on its own. Further, Section 424B of the Companies Act, 1956 empowers the tribunal to make such inquiry as it may deem fit for determining whether any industrial company has become a sick industrial company. Further, the Tribunal may, if it deems necessary or expedient so to do for the expeditious disposal of an inquiry, require by order any operating agency to enquire into the scheme for revival and make a report with respect to such matter as may be specified in the order. Operating agency is group of experts consisting of persons having special knowledge in banking & industry in which sick industrial company is engaged and includes public financial institution, State level institution, scheduled bank or any other any other person as may be specified by general or special order as its agency by the Board. Thus, Forensic Accountant can be part of operating agency and investigate whether the reference made by the company is genuine or the accounts are manipulated or fabricated to suit the scheme of reference made to NCLT to declare it as sick company and thereby siphon public funds.

#### 2) SEBI Act, 1992:

The share market is highly volatile and the brokers indulge into various unfair and fraudulent trade practices like synchronized share trading, manipulate and fabricate the books of accounts and cheat the gullible investors. Regulation 11 C of the SEBI Act, 1992 empowers the SEBI to direct any person to

investigate the affairs of intermediaries or brokers associated with the securities market whose transactions in securities are being dealt with in a manner detrimental to the investors or the securities market. Thus fraudulent and unfair trade practices of the brokers or market intermediaries are investigated by the investigator appointed by SEBI which require the broker or market intermediary to furnish information, books of accounts, registers, documents or records etc. which is analyzed by the investigator to find out any manipulation, fraudulent practice or otherwise of the broker. Thus, Forensic Accountant can play a lead role in assisting the SEBI to unearth the complex share related frauds perpetrated by the brokers.

3) [The Insurance Act, 1938:](#)

Section 33 of the said Act empowers the IRDA to direct any person ("Investigating Authority") to investigate the affairs of any insurer. The investigating authority may seek assistance of the auditor (or actuary or both) who shall be the Chartered Accountant within the meaning of Chartered Accountant Act, 1949 for the purpose of assisting him in any investigation. The books of account, registers and other documents are taken by the investigating authority in its custody to analyze it to find out the manipulations or fabrication in the books of accounts. Thus, Chartered Accountants plays a front role as an Forensic Accountant and aid in the investigation conducted into the affairs of the insurer as per the provisions of Insurance Act, 1938.

4) [The Prevention of Money-Laundering Act, 2002:](#)

Section 3 of the Prevention of Money Laundering Act, 2002 defines the offence of money laundering as involvement of a person in any process or activity connected with the proceeds of crime and projecting it as untainted property. The three important stages in the money laundering process are:

- Placement: Physical disposal of cash acquired from illegal sources by depositing the cash in domestic banks or other kinds of financial institutions.
- Layering: Working through complex layers of financial transactions to distance the illicit proceeds from their source and disguise the audit trail.
- Integration: Making the wealth derived from crime appears legitimate.

Forensic Accountant can often be involved in the following antimony laundering activities:

- Investigating and analyzing financial evidence to establish a suspicious transaction;
- Developing computerized applications to assist in the analysis and presentation of financial evidence;
- Communicating their findings in the form of reports, exhibits and collections of documents that assist the banks in submission of the suspicious transaction reports to the regulator; and
- Assisting in legal proceedings, including testifying in court as an expert witness and preparing visual aids to support trial evidence.

## 5) [The Companies \(Auditor's Report\) Order, 2003:](#)

CARO, 2003 requires the auditor to report to the effect that if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern status. In order to carry out the duties, the auditor has to draw a corollary and reference to the section 293 Companies Act, 1956, AS 24 ('Discontinuing Operations') and to AAS 16 (Going Concern) and thereafter make his observations on this matter. It also requires the auditor to report on Frauds i.e.; if any fraud on or by the company has been noticed or reported during the year.

### [Expert forensic accounting evidence](#)

#### **Who is an expert witness?**

An expert witness is a witness, who by virtue of education, training, skill, or experience, is believed to have knowledge in a particular subject beyond that of the average person, sufficient that others may officially (and legally) rely upon the witness's specialized (scientific, technical or other) opinion about an evidence or fact issue within the scope of their expertise, referred to as the expert opinion, as an assistance to the fact-finder. Expert evidence is evidence given to a court or tribunal by a person, skilled and experienced in some professional or technical sphere, of the conclusions he has reached on the basis of his knowledge, from facts reported to him or discovered by him by tests, measurements or similar means. It is commonly given by, for example, doctors, chemists, surveyors, architects, accountants and the like. In a Scottish case, *Davie v Edinburgh Magistrates (1953)*, it was said that the function of an expert witness "*...is to furnish the judge with the necessary scientific criteria for testing the accuracy of his conclusions, so as to enable the judge to form his own independent judgment by the application of those criteria to the facts proved in evidence*".

#### **An expert witness is different from ordinary witness**

Expert witnesses have a different status from ordinary witnesses when giving evidence at a Court or other judicial or quasi-judicial tribunals. The evidence of the "expert" differs from that of the ordinary witness who testifies as to facts observed, in that the expert is permitted to express his/her opinion on a matter that has occurred in the past, or may occur in the future which have not been actually observed by the expert, who is providing evidence. The relevance and weight which the Court or tribunal will attribute to such an opinion within the total evidence which is adduced is a matter for the Court or tribunal.

An expert, unlike other witnesses, is allowed, because of his special qualifications and/or experience, to give opinion evidence. It is for his opinion evidence that he is called, not for his view of the facts or circumstances of the dispute, although his interpretation of the facts is often necessary in order to explain and/or justify his conclusions.

#### **Forensic Accountant as an Expert Witness:**

The tradition and law relating to the status of the experts as witnesses dates back to English Courts around 1550. However, the first recorded use of an accountant as an expert witness was in *Meyer V. Sefton*, 2 Stark. 274 (1817). The use of Forensic Accountant testifying as an expert witness in the Court of law is becoming increasingly prevalent today in view of the rapid increase in the financial fraud cases.

In court cases where the knowledge of an expert can help to better explain the facts in issue or relevant facts, an "expert witness" may be called upon to give expert testimony.

Section 45 of the Evidence Act which makes opinion of experts admissible, lays down that when the Court has to form an opinion upon a point of foreign law, or of science, or art, or as to identity of handwriting or finger impressions, the opinions upon that point of persons specially skilled in such foreign law, science or art, or in questions as to identity of handwriting, or finger impressions are relevant facts. However, neither the Indian Evidence Act nor there is any seminal judicial pronouncements which clarifies as to when, how and under what circumstances, the testimony of Forensic Accounting Expert would be admissible or inadmissible.

In order, to bring the evidence of a witness as that of an expert it has to be shown that he has made a special study of the subject or acquired a special experience therein or in other words that he is skilled and has adequate knowledge of the subject. The Cost Accountant or Chartered Accountant can be considered as an expert to give testimony within the meaning of Section 45 of the Evidence Act. Moreover, the draft of "The Companies Bill, 2008" includes the definition u/s 2 (1) (zn) which interalia includes Cost Accountant and Chartered Accountant in the definition of "Expert" which can be also considered/extended for relying upon their testimony in the Criminal/civil cases by the court.

In USA, however, the admissibility of the Forensic Accounting Expert testimony is supported by the Judicial Pronouncements and Federal Rule of Evidence. Over the years, the US Supreme Court has delivered several decisions clarifying its standards for the admission of expert testimony:

In *Frye v. U.S.*, the Court stated that expert testimony will be admitted if based on a methodology "generally accepted" by the scientific community.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993) the Court concluded that the trial judge must act as a gatekeeper for expert testimony, considering several nonexclusive factors applicable to the testimony's reliability and relevance, including:

- Whether the theory or technique has been or can be tested,
- Whether the theory or technique has been subjected to peer review or publication,
- The known or potential rate of error, and
- Whether the theory or technique is generally accepted in the relevant scientific community.

Although *Daubert* focused on the admissibility of scientific expert testimony, its progeny have had a great impact on Financial Expert testimony. In *Kumho Tire Co. V. Carmichael*, 526 U.S. 137 (1999), the Court made clear that the gatekeeper function applies to all expert testimony, not just scientifically-based testimony.

Rule 702 of the Federal Rules of Evidence effectively codifies the Supreme Court's decisions in "*Daubert*" and "*Kumho*". Rule 702 provides that if the Court finds that scientific, technical or other specialized knowledge "will assist the trier of fact to understand the evidence or to determine a fact in issue," and if the Court finds that the witness is qualified as an expert "by knowledge, skill, experience, training, or education," then the Court may permit the witness to testify — so long as the witness' testimony is



based on "sufficient facts or data," the testimony "is the product of reliable principles and methods," and the witness has "applied the principles and methodology reliably to the facts of the case.

Further, concerning determinations of nonscientific expert testimony reliability, financial expert testimony (which includes Forensic Accountant Testimony) in particular, the Advisory Committee on the Federal Rules of Evidence and the Standing Committee on Rules of Practice and Procedure ("Committee") which proposed amendments to the texts of Rules 701, 702, and 703, specifically observed:

*"Some types of expert testimony will not rely on anything like a scientific method, and so will have to be evaluated by reference to other standard principles attendant to the particular area of expertise. . . . The expert's testimony must be grounded in an accepted body of learning or experience in the expert's field, and the expert must explain how the conclusion is so grounded. "Whether the testimony concerns economic principles, accounting standards, property valuation or other non-scientific subjects, it should be evaluated by reference to the 'knowledge and experience' of that particular field."*

Therefore, under the Federal Rules of Evidence, a judge will permit an accountant to testify as an expert witness only if the judge decides that:

The accountant's testimony will help the jurors or judge understand the evidence or determine a fact in issue.

The accountant is qualified as an expert by knowledge, skill, experience, training, or education.

The accountant can show that his or her testimony (a) will be based on sufficient facts or data and (b) will be the product of reliable principles and methods that have been applied reliably to the facts of the case. (These requirements are often referred to in shorthand as "qualification, reliability, and fit.")

Thus, under the rule announced in *Daubert v. Merrill-Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993) and expanded in *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999), the courts must ensure that experts-scientific and otherwise-will offer testimony that is methodologically sound and relevant to the facts of the case before admitting their expert testimony.

### Qualifying as an Expert Witness

Challenges to financial expert testimony have skyrocketed in recent years. Since *Daubert v. Merrell Dow Pharmaceuticals, Inc.* (1993), an increasing number of testifying experts have been subjected to challenges by opposing counsel in an attempt to prevent the experts from testifying (*Journal of Forensic Accounting*: 1524-5586/Vol.IV(2003), Page-113). Figlewicz and Sprohge in their article, "The CPA's Expert Witness Role in Litigation Services: A Maze of Legal and Accounting Standards," offer ten guidelines to help avoid legal challenges:

1. Know the relevant professional standards.
2. Apply the relevant professional standards.
3. Know the relevant professional literature.
4. Know the relevant professional organizations.
5. Use generally accepted analytical methods.
6. Use multiple analytical methods.
7. Synthesize the conclusions of the multiple analytical methods.



8. Disclose all significant analytical assumptions and variables.
9. Subject the analysis to peer review.
10. Test the analysis-and the conclusions-for reasonableness.

Now the various investigation agencies such as Police, CBI etc. are taking the help of CA/CWA as a Forensic Accountant and using their report as evidence in the cases of criminal/civil nature. Whether the aforesaid principles/guidelines laid down by the two US Supreme Court Judgments incorporated into Federal Rules of Evidence would be followed by Indian Courts or not will become clear in the due course of time.

However, the fact is that though till today there is general acceptance of admissibility of scientific evidence and expert's opinion in Indian Courts, there is no special law with respect to this which lays down criteria, principles or guidelines in clear terms with regard to when the expert opinion would be admissible and when it will not as is the case under the US federal law. Section 45 of the Indian Evidence Act is insufficient in this regard. However, in case of doubt, the principles laid down by US Supreme Court can be adhered to. In conclusion, one should understand that it is ultimately for the Court Of Law to decide as to who is qualified as an expert by knowledge, skill, experience, training or education, who may testify thereto in the form of an opinion or otherwise if:

1. The testimony is based upon sufficient facts or data,
2. The test is the product of reliable principles and methods, and
3. The witness has applied the principles and methods reliably to the facts of the case

However, no doubt, with the rapid increase in the cases involving misappropriation of funds, manipulation of books of accounts, banking fraud cases, Securities scams etc. involving complex financial transactions, the Forensic Accountants and admissibility of their testimony needs to be elucidated and these would be determining factors for deciding the fate of these cases. The involvement of Forensic Accountant in financial fraud cases and his testimony will not only take these cases to logical conclusion but also will go a long way ahead to put a curb on these menace of white collar offences.

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