

EXPERT WITNESSES

Watch out for the hidden assumptions in accountants' reports

By Ivor Gottschalk

The role of those preparing a damages report in civil litigation is to assess the financial impact of an alleged action or inaction by one of the parties. They must, by necessity, deal with the hypothetical — and hence make assumptions.

However, even in reports prepared by forensic accountants, the assumptions themselves are often not apparent, let alone their justification.

In one case, one of the “Big Four” accounting and auditing firms made assumptions in a damages claim on behalf of its client that contradicted the assumptions made on the same issues when it prepared the client’s financial statements.

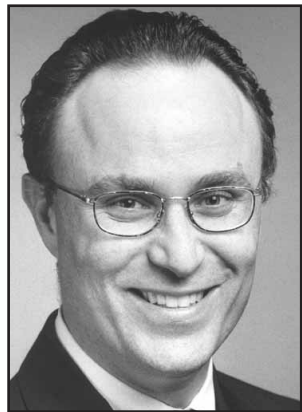
The manufacturer of a wood product sued its supplier of wood finish when customers complained that the finish was flaking. The manufacturer’s Big Four accounting and auditing firm was retained to prepare a preliminary estimate of the loss caused by the flaking problem. For the preliminary report, the firm prepared accounting schedules without a report.

Of the estimated losses of \$2.3 million; \$800,000 was for inventory on hand when the finish had been applied. “Notes” in an accounting schedule — the accountant’s equivalent of small print — are comments that provide further detail or explanation with respect to specific numbers in the schedule.

A “note” detailed the calculation of the damaged inventory as the quantity multiplied by the cost price. In effect, the loss had been assumed to be the company’s raw material and manufacturing cost of the wood product. No consideration was given to the possibility that the inventory could be refinished — in which case the loss would be the cost of refinishing, which was only about a third of the total raw material and manufacturing cost.

We were retained by the wood finishing company’s counsel, who arranged for us to visit the plaintiff’s manufacturing facility. Among the documents we asked to see was the calculation of the company’s inventory obsolescence provision. We found that for financial statement purposes approximately one-third of the inventory had been considered to be obsolete and the remainder was included in inventory for financial statements purposes. This confirmed that the loss was the cost to refinish (about \$266,000) rather than the full raw materials and manufacturing cost (\$800,000).

After we reported this contradiction between the financial statements and damages report,



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the Big Four firm withdrew as experts on the litigation and did not appear at trial.

In another case, a forensic accounting boutique firm was hired on behalf of a developer to prepare an estimate of lost profits on an incomplete construction project. By merging the projected loss from the construction project with profits from another project of questionable relevance, the firm showed only the net profit from the two and did not disclose the loss on the

project at issue, *i.e.*, the construction project. The developer’s bank called the construction loan when the developer could not raise additional financing to complete the over-budget construction project. As additional security for this construction loan, the bank held a second mortgage on a separate parcel of undeveloped land owned by the developer. This undeveloped parcel of land was forfeited to another lender of the developer (unrelated to the developer’s

bank) without any amounts being realized by the bank.

The boutique firm set out to estimate the “damages” (lost profit) that would have placed the developer in the same position as it would have been had the bank not called the loan. The boutique firm disclosed that its estimate of lost profit included not only the construction project but proceeds from selling the undeveloped parcel.

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Expert witness immunity is under attack in U.S.

By Geneviève Magnan

Based on considerations relating to administrative efficiency and general benefit to the public, courts have traditionally conferred immunity on expert witnesses. The underlying justification for expert witness immunity has traditionally been that it is not conferred for the individual benefit of the witness, but rather for the benefit of the public in the form of a more efficient administration of justice.

As sound as the concept of expert witness immunity may seem in theory, in practice its shortcomings are evident. One negative by-product of expert witness immunity is the absence of recourse for individuals who have incurred damages, often substantial, as a result of an expert witness's negligence.

While experts can be accused of perjury or face disciplinary sanctions from professional regulators, these remedies in no way provide reparation for the injured party. It is clear that witness immunity serves a very important role in our judicial system; however, given the equally important objective that people who suffer harm be afforded recourse before the courts, should immunity really

be extended to negligent expert witnesses? Do the benefits of expert witness immunity outweigh its detriments in cases of blatant negligence?

Over the past 15 years some American cases have refused to endow an absolute nature to expert witness immunity, thereby allowing liability suits to proceed.

The traditional common law approach has been to interpret expert witness immunity as precluding liability for negligence. Expert witness immunity stems from the general witness immunity which has been developed over hundreds of years by the common law. In *Royal Aquarium and Summer and Winter Garden Society v. Parkinson*, [1892] 1 Q.B. 431 at 451, Lord Justice Lopes qualified this immunity as "established beyond all question" even when "spoken maliciously, without any justification or excuse, and from personal ill-will and anger against the person defamed."

In Canada, the scope of witness immunity is interpreted very broadly. Indeed, Canadian courts have determined that where the plaintiff's relationship with the witness arose from the judicial proceedings, the witness is protected against suit by the immunity.

Although courts in the United States remain divided on this issue, and while denial of expert witness immunity has occurred in cases of professional negligence primarily for so-called "friendly" expert witnesses, this is not to say that absolute privilege for expert witnesses is a thing of the past.

Experts in the United States are still immune from liability for testimony given in the course of judicial proceedings, but the scope of this immunity is more restricted than in Canada. Thus, although the United States Supreme Court reaffirmed the concept of absolute witness immunity in *Briscoe v. LaHue*, 460 U.S. 325, 103 S.Ct. 1108 (1983), it also restricted absolute immunity to "the precise confines of adversarial judicial proceedings."

The differences in the Canadian and American approaches to expert witness immunity may be explained by a greater readiness in the United States to acknowledge a unique relationship between experts and the party that retained their services. More specifically, many American courts have emphasized the exceptional nature of absolute privilege to the general rule of civil liability and have sought to limit the scope of this application of the exception. The courts still seem reluctant to deny immunity to adverse expert witnesses, following from the "duty" an expert is said to have to the party having retained his or her services; an adverse witness has no such duty.

In *Bruce v. Byrne-Stevens*

and *Associates Engineers Inc.*, 776 P. 2d 666 (Wash. 1989), the appellate court reversed the decision by the trial judge to dismiss a claim against a "friendly" expert on the basis of witness immunity. In its reasons, the



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appellate court alluded to the financial motives that had prompted the expert to testify in an action, concluding that he was not "a bystander who fortuitously came to have information relevant to the claim, nor was he subjected to contempt of court if he refused to assume this undertaking."

Although the case was eventually reversed by the Washington Supreme Court, the dissent made clear that the purpose of absolute witness immunity was not "to shield an expert from otherwise actionable malpractice."

On the heels of *Bruce*, the California Court of Appeal allowed an action in negligence against a "friendly" expert witness in *Mattco Forge v. Arthur Young & Co.*, 6 Cal. Rptr 2d 781

(Cal. Ct. App. 1992). The court affirmed that statutory litigation privilege applied to opposing expert witnesses but did not act as a shield barring suits for negligence against a party's own expert. The court also distinguished *Bruce*, in which claims of malpractice arose from testimony given in court.

In *Mattco*, the expert accountant was never called upon to testify, as the actual case was dismissed. The defendant had therefore not sworn an oath and had not been subject to cross-examination, nor had prosecution for perjury been a possible outcome. The absence of other safeguards against negligence also militated in favour of allowing the action to proceed.

The denial of immunity was also affirmed by the Missouri Supreme Court's decision in *Murphy v. A.A. Matthews*, 841 S.W. 2d, 671, 680 n. 8 (Mo. 1992). In *Murphy*, where the defendant had testified, the court held that the policy considerations underlying witness immunity were not served by immunizing expert witness testimony from suits initiated by the retaining party.

Recently, the considerations put forth in *Murphy* were expounded upon by the Supreme Court of Louisiana in *Aizenhavar J. Marrogi v. Ray Howard and Ray Howard & Associates Inc.*, 805 So. 2d 1118, (2002 La).

"Th[e] exception [to general tort liability] should not be extended and broadened by applying the privilege of witness immunity to retained or friendly experts so as to shield them from a malpractice suit by the party that hired them."

This approach stands in stark contrast to the one generally taken by Canadian courts. In Canada, absolute immunity remains the rule not the exception; it seems to be firmly entrenched in our law, and its scope should not be unduly restricted. Removing obstacles to negligent expert witness liability is generally seen as inconsistent with the objectives sought by witness immunity.

Notwithstanding the unanimity of Canadian judgments affirming expert witness immunity, the American precedents that allow for expert witness liability in cases of negligence are starting to be invoked before Canadian courts.

Whether the Canadian development of this doctrine will mirror that in the United States remains to be seen.

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Check the accounting schedules

DAMAGES

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It therefore attributed the forfeiture of this undeveloped parcel to the bank on the apparent assumption that the bank's actions on the construction project had jeopardized the developer's ability to meet its payment obligations on the loan secured by the undeveloped parcel. The boutique firm also made the very significant assumption that the undeveloped parcel would be developed before it was sold — a highly speculative assertion.

Using all the other assumptions of the boutique firm, we separated the projections relating to the construction project and the undeveloped parcel. This revealed that the boutique firm had actually estimated a loss from the construction project, offset by profits from the undeveloped parcel. The boutique firm's undisclosed estimated loss on the construc-

tion project vindicated the bank's decision to call the loan on the project. The amount of work involved in identifying and segregating the impact of this very significant assumption was likely a fraction of the amount of work required to prepare the boutique firm's report. A significant part of the boutique firm's report was rejected by the court as "inherently flawed." The case settled for a fraction of the claim.

The above examples illustrate that assumptions and their implications may not be apparent to the reader of a plaintiff's damages report. Without a careful analysis of the report — and perhaps more particularly the underlying accounting schedules and calculations — implicit assumptions will remain hidden.

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