Auditing: Madoff Securities

– Case Study Presentation

Jonas Herbermann

MADF
BERNARD L. MADOFF
INVESTMENT SECURITIES LLC
New York □ London

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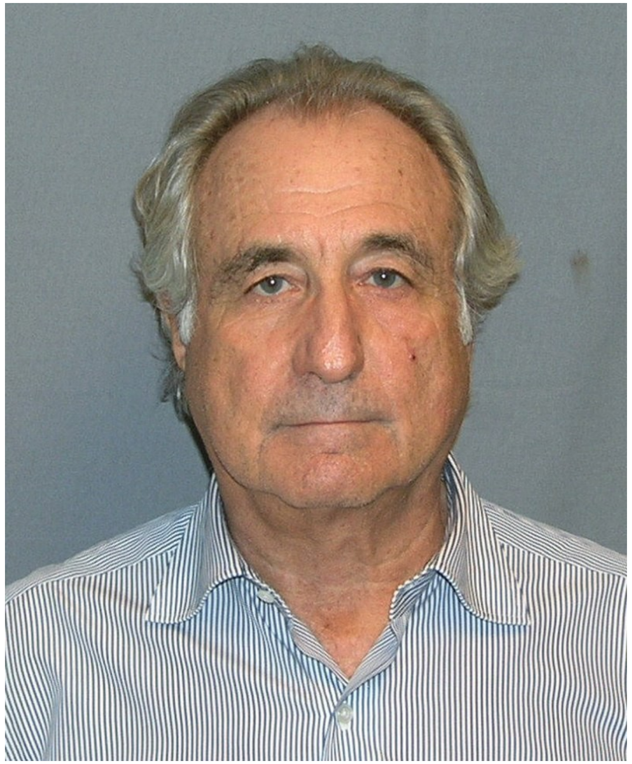
Bernard Lawrence Madoff



Bernard Lawrence Madoff

- Born on April 29, 1938, in New York City
- Graduated in 1960 with a political science degree
- He always wanted to get rich
  - Madoff frequently visited Wall Street and dreamed of becoming a “major player” in the world of finance
- In the summer of 1960, Madoff used his accumulated funds to establish Bernard L. Madoff Investment Securities LLC

Taking on Wall Street

Security Market in the US

- Securities of the most large companies were traded on the New York Stock Exchange (NYSE)
- The rules of NYSE made it difficult for small brokerage firms to compete with the cartel of large brokerage firms that effectively controlled Wall Street.
- Madoff and other small brokers insisted that the NYSE's rules were anticompetitive
- Madoff was convinced that the major brokerage firms kept securities transaction costs artificially high

Madoff's Mission

- Madoff made it this mission to “democratize” the securities markets in the United States while at the same point reducing the transaction costs of trading securities
- He pushed to automate the securities trading system, listing buyers and sellers on a computer that anyone could access

The impressive Growth of Madoff Securities

Madoff Securities

- Started with trading of securities of small over-the-counter companies (“penny stocks”)
- One of the first brokerage firms to utilize computers to expedite the processing of securities transactions
- The leadership role of Madoff Securities in the development of electronic securities trading contributed to the firm’s impressive growth (in the early of 21th century: largest market maker on the NASDAQ, among the largest market makers on NYSE with around 5%)
- The market market-making service was highly profitable and low risk

- In 1962 the company expanded to include investment advisory services
- Investment advisory became the most important line of business (in 2008 Madoff Securities managed $65 billion)
- The reason for the fast growth was the impressive rate of return (10-15% annually even in years of stock market decline)
- Most of the money entrusted to Madoff Securities was from so called “feeder firms”

The Detection of Madoff’s Fraud

The End of Madoff Securities

- On December 10, 2008, Bernie Madoff told his two sons who worked at Madoff Securities that the investment advisory division produced the impressive return fraudulent by an elaborate Ponzi scheme
- Madoff stated that the he did this without the knowledge of his employees and family
- Madoff’s sons notified the SEC and Madoff got arrested immediately
- The public was stunned that such a massive investment fraud could go undetected for several years even after the implementation of the regulatory reforms after the Enron and WorldCom debacles
- The accounting profession was among the first targets of the public’s anger

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Problem with the Independent Audit

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Independent Auditor

- The auditor of Madoff Securities was Friehling & Horowitz
- The auditor issued unqualified opinions on the financial statements of Madoff Securities since the early 1990s

Red Flags

- Nearly $200,000 in annual audit fees (independence problem)
- Friehling & Horowitz had only one active accountant (capacity problem)
- David Friehling had maintained dozens of investment accounts with Madoff Securities (independence problem)
  - Friehling, his accounting firm and his family had nearly $15 million invested funds managed by Madoff
- Friehling had reported each year that he did not perform any audits (no control system for audit form)
  - Friehling & Horowitz was a member of the American Institute of Certified Public Accountants (AICPA)
  - As a result Friehling & Horowitz was not required to have a periodic peer review (not mandatory in the state of New York at that time)

No Detection of the Fraud by the SEC

Investigations by the SEC

- On at least 8 occasions, the SEC investigated alleged violations of securities laws by Madoff Securities
  - In each case the investigation concluded without charging Madoff with any serious infractions of those laws
  - These investigations resulted from complaints filed with the SEC by Harry Markopolos
- Markopolos told the SEC that Bernie Madoff was operating the world's largest Ponzi scheme
  - He supported his accusation with several documents and evidence and identified 29 "red flags"

Red Flags

- Refusal of Madoff to allow a Big 4 auditor to review his financial records
- Madoff Securities was audited by a one-man accounting firm
- Madoff Securities did also not provide their clients with online access to their accounts
- Mathematical analysis that the Madoff's investment strategy could not generate the reported investment results

The Reasons for not detecting Madoff’s Fraud

Markopolos’s key factors

1. Madoff targeted investors who were unlikely to question his investment strategy
   - Smart investors would refuse to invest in a black-box-strategy
   - Greedy investors handed their money to Madoff
2. Madoffs impeccable credentials
   - Wall Street icon (pioneer of electronic securities trading, chairman of NASDAQ)
   - He regularly contributed large sums to several charities
3. Failure of the regulatory oversight function for the stock market
   - SEC should have been more diligent in fulfilling their responsibilities
   - SEC’s specialists were incapable of understanding a derivative-based Ponzi scheme

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Identification of those responsible and reforms

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Identification of the responsible persons

- Madoff claimed that he alone had been responsible for the fraud (sentenced to prison for 150 years)
- David Friehling (auditor) pleaded guilty to numerous charges like securities fraud (sentenced to prison for 100 years)
- Big Four accounting firms also faced law suits due to their audit of large “feeder firms” that entrusted billions of $ to Madoff
  - The SEC said that the auditors of the feeder firms had a responsibility to check out Madoff’s auditor

Proposed Reforms

- The failure of Friehling’s firm to undergo any peer reviews leaded New York state legislature to pass a new legislation
  - Requiring New York accounting firms that provide attest services to be peer reviewed every three years
- The new SEC Chairman reported that the SEC would revamp its oversight policies and procedures for investment advisers
  - Surprise audits
  - Requirement to have internal control audits by independent accounting firms
  - Specific measures to ensure that allegations by whistle-blowers would be investigated better

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Question 1

Question

- Research recent developments involving this case. Summarize these developments in a bullet format.

Answer

- Lawsuits against many companies that invested in Madoff Securities (e.g., Aurelia Finance, Grupo Santander)
- Madoff’s brother Peter Madoff was sentenced to 10 years in prison for his involvement in the Ponzi scheme
- Many suicides, most noticeable Madoff’s elder son, Mark Madoff
- The SEC conducted an internal investigation and released a 477-page report on how they missed the fraud
- JPMorgan where Madoff kept his bank account payed a settlement of $1.7 billion to resolved any potential criminal case
- Irving Picard and his team have been overseeing the liquidation of Bernard Madoff’s firm in bankruptcy court
  - recovered over $13 billion—about 76 percent of approved claims—by suing those who profited from the scheme
  - Usually in such schemes recovery of money ranges from 5 percent to 30 percent

Question 2

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Question

- Suppose that a large investment firm had approximately 10 percent of its total assets invested in funds managed by Madoff Securities. What audit procedures should be investment firm's independent auditors have applied to those assets?

Answer

- Use the understanding of the client and its environment to consider inherent risks, including fraud risk related to financial investments
- Obtain an understanding of internal controls over financial investments
- The investment has high relevance for the performance of the company and is extremely material
  - Because of that you must perform substantive tests regarding this investment
  - Lynn Turner, a former chief accountant of the SEC, contends that the auditors of the feeder firms had a responsibility to check out Madoff's auditor

Question 3

Question

- Describe the nature and purpose of a “peer review”. Would peer reviews of Friehling & Horowitz have likely resulted in the discovery of the Madoff fraud? Why or why not?

Answer

- Peer review helps to monitor a CPA firm’s accounting and auditing practice
- Peer reviews ensure that CPA firms are preforming at a high standard and offer firms opportunities to improve the quality of their services and processes
- Peer reviews are conducted by licensed CPAs who meet specific requirements e.g.,
  - Be currently active in public practice at a supervisory level in the accounting or auditing function
  - Be associated with a firm that has received a report with the peer review rating of pass for its most recent System or Engagement Review
  - Have at least five years of recent experience in the practice of public accounting in the accounting or auditing function
- A peer review of Friehling & Horowitz could have discovered the fraud because the peer review would probably criticize the too small capacity of the firm for the audit of Madoff Securities and the independence problem arising from the investment accounts of Friehling at Madoff Securities

Question 4

Question

- Professional auditing standards discuss the three key “conditions” that are typically present when a financial fraud occurs and identify a lengthy list of “fraud risk factors”. Briefly explain the difference between a fraud “condition” and a “fraud risk factor” and provide examples of each.

Answer

- The difference between fraud conditions and fraud risk factors is that the conditions describe an environment in that fraud is committed and the fraud risk factors describe different factors present in a company that incentivize fraud
- The key fraud “conditions” are perceived opportunity, incentive and rationalization
- Fraud risk factors are for example
  - Nature of Items: Size and value, Ease of resale, Cash
  - Nature of the Control Environment: Separation of duties, Documentation
  - Pressures: Expectations form outside investors, members of management have guaranteed company debt

Question 5

Question

- In addition to the reforms mentioned in this case, recommend other financial reporting and auditing-related reforms that would likely be effective in preventing or detecting frauds similar to that perpetrated by Madoff.

Answer

- Additional requirement for firms that invest entrusted money to disclose information about their investments in the financial statement
- Use of third-party financial experts in investigations of the SEC if the investment strategies are too complex
- Disclosure of the investments of key executives in an audit engagement to see if their independence is at risk
- “We didn't need any new rules in order to prevent Bernie Madoff from happening. We needed to enforce the old rules.“ (Richard Painter, a professor of corporate law at the University of Minnesota)
- “The key fact is that the SEC's enforcement budget has not grown in proportion to the size and growth of the market” (John Coffee, a professor at Columbia University Law School)

Thank you for your attention!

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