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AUDITOR LIABILITY

The Madoff Matter

THE RECENT, shocking news about the \$50 billion Ponzi-scheme fraud allegedly perpetrated by investment adviser Bernard Madoff has been one of the most headline-grabbing events of the past month, noteworthy even amidst the almost daily “can you top this” revelations about massive government economic interventions and the falling-domino-like series of industry-by-industry bailout demands. If true even remotely as reported, the Madoff affair is bound to raise fundamental questions about auditor liability, going far beyond the apparent issue of regulatory failure. Many of these concerns will quite possibly culminate in litigation targeting accounting firms.

Madoff operated a family-run stock trading firm, which thus far has not been subject to allegations of fraud, and a supersecret investment advisory firm, which is purportedly the locus of the fraud. The advisory firm had been producing rather remarkable and implausibly stable returns for several decades, and was flagged by several whistleblowers who, alas, were unable to generate requisite curiosity among the regulators. Both of these entities would have been subject to U.S. Securities and Exchange



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Commission oversight, although, for reasons yet unknown, the investment advisory firm did not register until 2006—at which time it should have been subject to an examination by the SEC.

Trading firm's auditors likely noted some anomalies

Published reports state that the Madoff advisory firm forwent the traditional profit-sharing arrangement with its investors, instead relying only on commissions on trades presumably made through the Madoff trading firm. This business model would probably have provided an important nexus between the advisory firm and a firm that had been regulated and audited for many decades. The auditors for the broker-dealer would thereby have obtained not only insights into the “related party” transactions—always a high-risk and thus close-attention area for auditors—but also an understanding of the scope and nature of the investment advisory firm's operations.

Arguably, this should have made it reasonably likely that the trading firm's auditors would have noted certain remarkable anomalies, which should have served as “red flags” of possible fraud.

For example, news reports state that Madoff's advisory firm touted “proprietary” trading strategies that involved, according to one published calculation, the trading of more stock options than the entire market reported during the same periods—thus, an impossibility. Had auditors, in pursuit of information about “related-party transactions” between the trading and advisory firms, made the effort to learn of these investment adviser claims—which would have been unsupported by broker-dealer trading records—this might have triggered further investigations and unraveled the long-standing fraud years ago.

Although many more facts will need to be fully digested, it appears possible that there will be grounds for claims to be made against multiple accounting firms. Those will include firms whose clients had either direct or indirect investments in Madoff or his investment vehicles, as well as accounting firms providing a range of accounting and tax services for individual investors whose net worth was more than trivially tied up in those investments. Given the staggering losses being claimed, there will be predictable efforts to place blame on various intermediaries and, probably to a large measure, on auditors and accountants whose work was relied upon by the aggrieved parties.

The type or level of services provided to specific clients will be a key determinant of their exposure for liability and damages. Although in most instances the accountants will not have been engaged to verify the existence or valuation of the Madoff-related investments per se, the magnitude of those investments in relation to the financial statements of the investing parties—what accountants refer

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to as materiality—will almost inevitably be such that a failure to have addressed these matters could be actionable. Despite the accounting profession's decades-long efforts to define materiality, it ultimately lies in the eyes of the beholder, and in litigation those beholders are most often jurors whose frames of reference will provide little basis for sympathy toward accountants who failed to apply basic procedures designed to verify these purported investments.

As to liability arising from compiled financial statements (which merely involve the assembly of information provided by the client, with neither positive nor negative assurances offered by the accountants), the charge is usually gross negligence, tied to a failure to note "obvious" anomalies on the face of the balance sheet. While such claims normally settle for modest amounts, harm to one's reputation and the "opportunity cost" of being distracted for months or years by legal proceedings can dwarf actual cash settlements.

The largest dollar settlements arising from accountants' malpractice claims arise in connection with failed audits performed for major companies. When publicly held companies are involved, there will often be derivative suits and class actions asserting huge damages figures. Even private entities, if harmed by auditor negligence, may seek large awards for lost profits and other "consequential" damages, as well as refunds of audit fees paid, since the promised services were not really delivered. Notwithstanding assorted attempts at "tort reform" over the years—such as the 1995 private securities litigation reform—auditors are enormously vulnerable when audit failure of a caliber greater than mere "ordinary negligence" can be successfully argued.

Besides the Madoff firms' auditors (reportedly a very small practice in upstate New York), the auditors for the various conduits and intermediaries that reportedly funneled their respective clients' funds to Madoff for investment are at risk. So, too, are the auditors for the various entities, including public charities and private foundations, likely to be pursued for malpractice. Some charities and "fund of funds" investment vehicles have, reportedly, already shut down due to losses incurred. In instances in which those investments were material to the audited

balance sheets, the auditors would have been obligated by professional standards to perform a range of audit tests and other procedures regarding assertions about the existence and valuation of these investments. If the fraud allegations are true, these procedures could not have been adequately performed.

It is probable that these investments were material (large) assets on the balance sheets of the respective investors. Given that, in most or all states, charities and other entities raising funds from the public must be audited, this suggests that auditors overlooked not the fraud per se

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(since audits cannot guarantee detection of fraud), but the most serious questions of the very existence and valuation of these presumptive assets. Missing that in the context of an audit would be hard to explain to a jury of one's peers.

Failure to apply standards could be gross negligence

Audits, of course, are not absolute guarantees of the propriety of the subject financial statements, nor of the honesty of the enterprise being reported upon. However, an audit must provide reasonable assurance (which is defined as being a high level of assurance—think a 90%-plus likelihood) that the financial statements are fairly presented and free from the effects of material error or fraud. Auditors are often unharmed by allegations of mere ordinary negligence, since absolute assurance is not offered. However, gross negligence, which is often equated with fraud, is often harshly dealt with by factfinders. A blatant failure to apply Gener-

ally Accepted Auditing Standards, such as by not obtaining relevant substantiation for the valuation of material investments, could be prima facie evidence that gross negligence, or worse, occurred.

Of the many dimensions to possible audit failure in connection with Madoff investors' financial statements, one likely but complex area will relate to internal control. An often-misunderstood concept, internal control is central to the planning and conduct of every audit, and absent an understanding of the controls implemented to ensure the accuracy of financial reporting by the client, auditors are essentially precluded from rendering "clean" opinions on the financial statements. Whereas another entity (say, the Madoff investment firm) provides primary accounting for material transactions of the audited entity (e.g., corporate investors in the Madoff funds), the auditors must either themselves gain that understanding or rely on so-called "service auditors" reports on those controls.

It has been reported that Madoff maintained a locked office on a separate floor for all the activities of his investment advisory firm and granted access to no one else—not even his sons, who were officers of the trading firm. It thus will be interesting to learn how auditors opining on financial statements of investors having material exposure to Madoff could have met this threshold requirement concerning an understanding of internal controls over the accounting for fund performance. In a world of "red flags" for the auditors, ignoring the secretiveness of the Madoff firm's operations would apparently set a high credibility threshold for accountants defending their work to overcome. **NLJ**

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