

Evaluating ethics of  
bernie madoffs  
investment securities  
fraud accounting  
essay



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Every business has an ethical responsibility not only to stakeholders but also to society at large. This responsibility should be in line with stakeholder interest and society's welfare. The government and regulators have a responsibility of ensuring that firms follow these ethical objectives. Failure to do so may lead to losses which will not only affect stakeholders but society at large. The financial fraud which was experienced in Bernie Madoff Investments in the US is a clear example of the losses which may be incurred due to failure to observe ethical responsibility by firms. Bernie Madoff operated his company, Madoff Investments in an unethical way and this led to severe consequences to stakeholders and society at large which incurred losses amounting to billions of dollars. Although he was later arrested and punished for the crimes, his victims have not been able to recover from the financial losses incurred and several developed illnesses associated with stress and depression over the effects of the scandal.

This paper will evaluate the Bernie Madoff financial fraud in relation to ethical responsibility of firms. The financial fraud practiced by Bernie Madoff will be analyzed in detail and the effects on stakeholders and society discussed. The ethical responsibility which firms have in relation to their stakeholders and society will also be analyzed in the paper. Finally, the measures which should have been taken by the government and regulators to prevent the Bernie Madoff scandal and other subsequent financial scandals will also be outlined in the paper. The discussed issues will be summarized at the end of the paper.

## **Introduction**

Business ethics is an important aspect of any business environment since it ensures that the objectives of firms are achieved in ethically acceptable ways. It also ensures that firms perform their ethical responsibility towards society in order to safeguard its welfare. Businesses are expected to undertake activities in a legal way which conforms to principles such as prudence, honesty, full disclosure, social and environmental responsibility among others. They are also expected to operate in way which is environmentally and socially friendly to the local community and society. Failure to conform to ethical requirements is usually detrimental to various parties involved in the business activities. These include the shareholders, community, government, suppliers or other parties which have a stake in a business.

Bernie Madoff is an American investment adviser and stock broker who operated Madoff Investments in an unethically acceptable manner. He used the company as a front to commit a Ponzi scheme which fleeced investors of over \$65 billion (Arvedlund, 2009). This has been regarded as the largest Ponzi scheme ever. Madoff grew up in a humble background and he established the Madoff Investments Company with support from the father in law. A few friends and family members also supported Madoff with the operations and growth of the business. Madoff used the returns from investment to support several charitable and political causes which his firm believed in.

However, in 1999, there was concern that the profits made by Madoff

Investments surpassed the normal profits expected from a firm in such a  
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venture. Markopolos, an expert in investments informed the exchange commission that it was not possible to achieve the level of profits which were achieved by Madoff Investments and it is possible that the firm engaged in fraud. Several investigations were undertaken during the next few years and in 2008, Madoff was unable to pay returns demanded by investors. It was then that he admitted that his investment scheme was a Ponzi scheme and he was later charged in court with fraud. Madoff was sentenced to 150 years and is currently serving his term. This paper will further discuss the Madoff securities scandal with reference to the ethical responsibility which organizations have against stakeholders.

## **Bernie L Madoff investment scandal**

Madoff undertook financial fraud through misrepresenting the nature of his business to investors and encouraging them to invest in his company. Madoff founded a company, Madoff Investments which dealt with investment of securities and shares. He began operating with a capital of approximately \$50, 000 but in a decade, this sum had increased to hundreds of millions of dollars (Fred, 2009). Potential investors saw the company as successful and they invested billions of dollars in the business. However, Madoff did not deal entirely with financial investments but he carried out a Ponzi scheme, with the financial investment as the front. He used investments by new shareholders to pay returns to earlier shareholders without really making profit from the capital invested. It is important to understand how Ponzi schemes work in order to explain Madoff's strategies. Ponzi schemes are financed by capital from subsequent investors. For instance, if investor A invested in 2000 and investor B invested in 2001, Madoff used the capital

invested by investor B to cover for the returns of investor A. Investor B's returns would subsequently be paid by capital invested by a new investor, C and so on (Fred, 2009).

In order to cover for the financial fraud, Madoff used the financial investments as a front for his fraud. He falsified return forms of investors and gave returns according to pre-determined rates in order to avoid raising suspicion. These returns, as explained, were financed by capital from subsequent investors. A computerized program was used to falsify the accounts and ensure that they balanced, to avoid suspicion from financial regulators. However, several people raised suspicion with the huge returns associated with Madoff Investments. It was seen as impossible to earn such high returns from trading in financial securities without engaging in fraud. In 1999, the first suspicions were raised although it took over ten years for the Ponzi scheme to be uncovered. This has been blamed by inefficiency by financial regulators and the US government. Effective investigations would have unearthed the scandal within the first five years of operation.

However, as is common with Ponzi schemes, it collapsed. These schemes collapse when returns required by previous investors surpass the investments made by new investors (Beach, 2007). When this happened to Madoff Investments, he confided to his family that the investment firm was a just front for conducting fraud through the Ponzi scheme and it did not in fact exist. One of his sons reported this to the police. This led to his subsequent arrest and he was charged in court. He pleaded guilty and received a sentence of 150 years. His family, including his wife apologized to the public

although their roles in the scandal were further investigated and they were cleared. Madoff is currently serving his term.

## **Ethical issues regarding Madoff investments**

It has been discussed in the introduction stage that businesses are expected to undertake their affairs in ethically acceptable ways which conform to social values. Businesses are expected to conform to principles such as prudence, honesty, full disclosure, social and environmental responsibility among others (Diller et. al., 2006). They are also expected to operate in way which is environmentally and socially friendly to the local community and society at large. Ethics usually dictates the way business undertake their operations and it is determined by organizational objectives, any professional ethics and government regulations when operating within the business environment. Firms usually follow business ethics to meet the needs of stakeholders while safeguarding the welfare of society (Beach, 2007).

There are various ethical issues which arose during the Madoff scandal and which are contrary to ethical requirements of businesses. One of these issues is fraud. Businesses are not expected to engage in fraud since it is not only against business interests, but it is also illegal under law. When Madoff and his staff engaged in fraud, they broke the ethical responsibility towards organizational stakeholders and in addition, they committed a crime. This led to his jail sentence of over 100 years. The second ethical issue which arises when analyzing the Madoff case is misrepresentation. Firms are required to follow the ethical responsibility of full disclosure to all organizational stakeholders (Fred, 2009). Misrepresentation is not only a breach of ethical <https://assignbuster.com/evaluating-ethics-of-bernie-madoffs-investment-securities-fraud-accounting-essay/>

requirements but it is also a crime. Madoff misrepresented the state of his firm's finances and a false belief that it was making profits. This is what attracted the thousands of investors to Madoff Investments.

Misrepresentation also enabled Madoff escape detection from financial regulators although there was suspicion on his illegal practices.

The third ethical issue which arises from the case study is money laundering. This is the use of a legal source of revenue to hide illegal sources of revenue or revenues which have not been declared or taxed by the government. This is an unethical practice which is a crime and is punishable by many years in jail. Madoff used his investment firm as a front to hide the revenues which were received through the Ponzi scheme. The investment firm was used to portray the business activities are legal and to hide the true sources of revenue. Money laundering is a crime which Madoff was charged with and it contributed to his long jail sentence.

### **How the investment negatively affected stakeholders**

There are several negative effects which Madoff Investments had on stakeholders. These will be analyzed on the basis of their relationship with the company.

#### Investors

Investors are some of the stakeholders who were worst affected by the scandal. The investment lost by investors surpassed \$65 billion, which is huge by all standards. The small scale investors were most affected since many were families and households in the middle income status. Families

which lost their investments suffered various adverse effects including health  
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problems associated with stress and depression which emanated from the losses (Eamon, 2008). Some investors passed away due to health complications occasioned by the shock of losing their lifetime savings. Others had their lifestyle changing in order to accommodate the losses, some of which arose from borrowed finance used to invest in Madoff Securities.

### Employees

Employees were also heavily affected by the Madoff Securities scandal since most lost employment opportunities. As a result of the inability of the firm to remain liquid, it was closed to ensure that further losses were not experienced by stakeholders (Eamon, 2008). Employees who relied on the firm for their livelihood lost jobs and many were unable to support themselves and their families. Some developed health complications from stress associated with loss of employment while others changed their lifestyle to accommodate their diminished income earning status. Although some employees secured employment in other firms, many suffered huge financial losses as the company was unable to compensate them for the job loss (Eamon, 2008).

### Creditors

Creditors also suffered from the closure of Madoff Securities. There was over \$100 million which was directly owed to creditors due to provision of outsourced services to Madoff Securities. It is important to note that these creditors were separate from shareholders. Some of the creditors were able to recover money owed while some could not (Eamon, 2008). This led to the <https://assignbuster.com/evaluating-ethics-of-bernie-madoffs-investment-securities-fraud-accounting-essay/>



closure of some of the firms which provided services and goods to Madoff Securities.

### Charities

There are various charities which suffered as a result of the closure of Madoff Securities. Some of the charities which were affected by closure of the firm include JEHT Foundation, Robert Lappin Foundation and Chais family Foundation. These charities heavily relied on financial support from Madoff Investments and without adequate funds, some were forced to scale down their operations and provide charity services to fewer people. In addition, some of the causes which were supported by Madoff Securities such as lymphoma research also heavily suffered as a result of the liquidation of the firm. Madoff contributed over \$4 million annually to support this research and the closure of Madoff Securities affected the funding towards lymphoma research (Eamon, 2008).

### Local communities

The local community also suffered from the closure of Madoff Securities from the fraud scandal. Madoff Securities supported various social causes which the communities identified with. The firm contributed generously towards community projects which were geared towards empowering the population. This was achieved through the corporate social responsibility programs. The firm also funded education and training opportunities for needy children in the local community. After the closure of the firm, some of these causes which were supported by Madoff Securities collapsed due to absence of donors who would propagate the work which had been started by Madoff  
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(Fred, 2009). Some of the children who would have been empowered through education also lost an opportunity after the firm was closed.

## Government

Finally the government experienced adverse effects due to the Madoff financial scandal. One of the major effects is the loss of potential tax revenues from the firm. The firm usually paid millions of dollars in annual tax and this source of finance was lost by the government. This affected the development programs and infrastructural developed usually paid for through this tax source. In addition, the government faced adverse publicity especially due to its inability to detect the scandal and act on time even through several red flags had been raised on the issue. It was also suspicious that Madoff supported certain government causes and political parties which may have been construed to explain why he was not arrested immediately after the scandal began.

## **The negative impact the investment had on the economy**

There is a macro aspect of the scandal which affected the overall American economy. Various costs were incurred by the government and economy at large, which negatively affected growth and development. The cost of the adverse health effects of the victims of the scandal including employees and investors were passed on to the economy. Investors and employees who became ill due to the stress and depression experienced partly increased the healthcare costs to the economy. The loss of manpower due to loss of jobs by employees compounded by losses incurred by investors and creditors was a huge cost to the economy. The government was partly responsible for

settling these victims and it also lost revenues from the closure of the Madoff Investment firm. These indirect and direct costs which were passed on to the government reduced the available income for infrastructural and social development in the US. As a result, the economic development and growth levels were affected by the scandal. The weight of the funds involved which was over \$60 billion, slowed down economic growth levels.

Another adverse impact to the economy is a decline in investment. Many investors who had invested in Madoff Securities lost their investments and this made them reluctant to invest in future (Arvedlund, 2009). Other investors who had invested in other companies also pulled out their investments in efforts to avert a crisis similar to the one experienced at Madoff Investments. The market generally adopted a cautionary approach towards investment since the Madoff Scandal discouraged consumers from investment. The decline in investment levels directly affected economic growth. For the economy to grow there has to be high investment levels. The decline in investment due to the scandal reduced the economic growth rate. The government heavily invested in encouraging the market to invest more in securities and shares.

## **How the scandal could have been prevented**

There are several measures which should have been taken to reduce the likelihood of the fraud scandal. Some of these measures should be implemented in future in order to discourage a similar scandal in the US business environment. Some of these measures will be discussed below;

### **Audits**

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Audits are effective in preventing fraud especially in cases where they are external in nature. Madoff did not carry out regular audits and he falsified documents in order to prevent the detection of the fraud which was being committed. External and internal audits should have been frequently undertaken in order to analyze the accurate financial position of the firm. These audits would have revealed the fraud in a timely manner and prevented further losses to the organizational stakeholders. Managers should undertake frequent audits in order to encourage ethical practices in business and to discourage fraud.

#### Accounting technology

Technology is also similarly effective in preventing accounting fraud. Technology should have been used to restrict access to information on Madoff Securities. Passwords, locks and others should have been used to restrict the confidential information and in the event that accounts were tampered with, it would have been clear on who gave authorization to access the records. Technology would also have been used to allow investors to access financial records of Madoff Investments online (Arvedlund, 2009). Access to such information would have revealed any illegal or unethical practices in the firm. Future managers should make use of technology to ensure that business operate in an ethically acceptable manner.

#### Employee motivation

Employee motivation is an effective tool in the operations of any firm. Employees have to be motivated if they are to operate in an ethical manner.

This is because employees with high motivation levels are proud of firms  
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they work in and are likely to only perform actions which are consistent with organizational goals. Such employees are therefore less likely to engage in fraud or other unethical behavior (Bateman, 2010). If the employees at Madoff Investments had high motivation levels, they would not have collaborated with Madoff in committing fraud and the scandal would have been exposed earlier. Managers should motivate employees by using both non financial and financial rewards in order to boost their performance and increase their loyalty to the firm.

### **Government action on the Madoff Scandal**

The government took several measures in order to mitigate the damage caused by the financial scandal and as well as discourage further scandals in future. The first action taken was to strengthen financial regulations and investigations into market players in the stock exchange (Wilhelm & Joseph, 2010). The government passed several regulations which firms were supposed to adhere to in order to ensure that they operated in ethically upright ways. Another step which was taken by the government was to develop legislation to discourage future financial fraud cases. The government developed harsh punishment for firms and people who are involved in financial fraud. This included heavy fines, prison sentences or both. These laws were passed by congress and they have been effective in discouraging fraud.

The government also took steps to retribute the victims of the scandal.

Various assets, revenues and accounts which were linked to Madoff

Investments were frozen and funds consolidated in efforts to pay back

investors (Wilhelm & Joseph, 2010). Small investors received priority when <https://assignbuster.com/evaluating-ethics-of-bernie-madoffs-investment-securities-fraud-accounting-essay/>

being compensated although larger shareholders also received a share of revenue collected. Creditors were also compensated for the services which they had rendered to Madoff Investments. However, most investors were not fully compensated for the losses incurred due to previous money laundering strategies which Madoff had undertaken.

### **Plea, sentencing, and prison life**

When Madoff was charged with the offense, he pleaded guilty for the offense. However he was not a cooperative witness and he did not reveal other people he conspired with to commit the financial fraud scandal. The judge had the option to fine him, jail him or apply both forms of sentences. The judge sentences Madoff to 150 years in prison, an equivalent of life imprisonment.

### **How investors should protect themselves from fraud**

There are different measures which investors should implement in order to ensure they are not victims of fraud. The first step which investors should take is demand regular audits of their firm. Audits should be demanded through their annual AGM meetings and these will encourage the management to operate within ethically acceptable ways. The second step is consulting external experts. Experts particularly those in the financial services industry should explain the projected returns on investments over a period of time. For instance, an expert would have explained to investors in the Madoff Investment scandal that it was impossible to receive such large returns within short time periods and this would have made them suspicious of the operations of the firm. This would have prevented the losses of investment made by shareholders.

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Finally, investors should pressure the management to make the accounts public especially when there are media reports about an impropriety by the management. In the Madoff scandal, investors were aware of adverse reports on the operations of the firm but they ignored these reports. If they had pressured the management to release financial statements, the fraud would have been exposed earlier and saved the investors billions of dollars. The investors should ensure that they have a timely and accurate view of the financial position of their firm at any one time.

### **Summary and conclusion**

This paper has discussed the Bernie Madoff financial fraud in relation to ethical responsibility of firms. The financial fraud practiced by Bernie Madoff has been analyzed in detail and the effects on stakeholders and society discussed. Bernie Madoff operated his company, Madoff Investments in an unethical way and this led to severe consequences to stakeholders and society at large which incurred losses amounting to billions of dollars. He used the company as a front to commit a Ponzi scheme which fleeced investors of over \$65 billion. This has been regarded as the largest Ponzi scheme ever. However, in 1999, there was concern that the profits made by Madoff Investments surpassed the normal profits expected from a firm in such a venture. Several investigations were undertaken during the next few years and in 2008, Madoff was unable to pay returns demanded by investors. It was then that he admitted that his investment scheme was a Ponzi scheme and he was later charged in court with fraud. Madoff was sentenced to 150 years and is currently serving his term.

There are various ethical issues which arose during the Madoff scandal and which are contrary to ethical requirements of businesses. One of these issues is fraud. Businesses are not expected to engage in fraud since it is not only against business interests, but it is also illegal under law. The second ethical issue which arises when analyzing the Madoff case is misrepresentation. Firms are required to follow the ethical responsibility of full disclosure to all organizational stakeholders. Madoff misrepresented the state of his firm's finances and a false belief that it was making profits. The third ethical issue which arises from the case study is money laundering.

There are several negative effects which Madoff Investments had on stakeholders. Investors are some of the stakeholders who were worst affected by the scandal. The investment lost by investors surpassed \$65 billion, which is huge by all standards. Employees were also heavily affected by the Madoff Securities scandal since most lost employment opportunities. Creditors also suffered from the closure of Madoff Securities. There was over \$100 million which was directly owed to creditors due to provision of outsourced services to Madoff Securities. There are various charities which suffered as a result of the closure of Madoff Securities. Some of the charities which were affected by closure of the firm include JEHT Foundation, Robert Lappin Foundation and Chais family Foundation. The local community also suffered from the closure of Madoff Securities from the fraud scandal. Madoff Securities supported various social causes which the communities identified with. After the closure of the firm, some of these causes which were supported by Madoff Securities collapsed due to absence of donors who would propagate the work which had been started by Madoff. Finally the



government experienced adverse effects due to the Madoff financial scandal. One of the major effects is the loss of potential tax revenues from the firm. In addition, the government faced adverse publicity especially due to its inability to detect the scandal and act on time even through several red flags had been raised on the issue.

There are several measures which should have been taken to reduce the likelihood of the fraud scandal. Some of these measures should be implemented in future in order to discourage a similar scandal in the US business environment (Wilhelm & Joseph, 2010). Audits are effective in preventing fraud especially in cases where they are external in nature. Managers should undertake frequent audits in order to encourage ethical practices in business and to discourage fraud. Technology is also similarly effective in preventing accounting fraud. Technology should have been used to restrict access to information on Madoff Securities. Future managers should make use of technology to ensure that business operate in an ethically acceptable manner. Employee motivation is an effective tool in the operations of any firm. Employees have to be motivated if they are to operate in an ethical manner. Managers should motivate employees by using both non financial and financial rewards in order to boost their performance and increase their loyalty to the firm (Bateman, 2010).

There are different measures which investors should implement in order to ensure they are not victims of fraud. The first step which investors should take is demand regular audits of their firm. Audits should be demanded through their annual AGM meetings and these will encourage the

management to operate within ethically acceptable ways. The second step is <https://assignbuster.com/evaluating-ethics-of-bernie-madoffs-investment-securities-fraud-accounting-essay/>

consulting external experts. Experts particularly those in the financial services industry should explain the projected returns on investments over a period of time. Finally, investors should pressure the management to make the accounts public especially when there are media reports about an impropriety by the management. They should ensure that they have a timely and accurate view of the financial position of their firm at any one time. This will ensure that firms operate in ethically acceptable principles and discourage unethical practices such as financial fraud.