improper incentives, confusing cash flow trends, and siloed departments, are more susceptible to fraud than others. Pick up on weak signals and take steps to ...

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In 2008, the FBI received a call from Mark and Andrew Madoff regarding their father's firm Bernard Madoff Investments, the world's largest private hedge fund. The hedge fund was a massive Ponzi scheme, the tipsters told investigators; the entire enterprise was a fraud. The Madoff investment scandal resulted in a $65 billion loss to investors, the largest Ponzi scheme in history. Madoff was sentenced to 150 years in prison, the maximum sentence allowed by law.

2008, however, was not the first time the federal government received credible

and delivered the SEC more evidence in 2001 and again in 2005. The SEC continued to pay him no heed.

Had the SEC listened to Markopolos eight years prior, billions of dollars and untold misery could have been avoided. But the SEC failed to notice the weak signals of fraud. Weak signals are warning signs that often precede a massive exposure of wrongdoing. In the wake of financial scandals, observers often conclude that, in hindsight, perhaps illicit behavior could have been thwarted far earlier. The symptoms of lurking financial wrongdoing are weak signals.

Oftentimes, the shock to stakeholders at the revelation of massive fraud is avoidable, should interested parties know how to identify and process the weak signals. Accountants have a significant role to play in detecting these weak signals and heading off the next massive financial fraud.

Accountants that do encounter weak signals of fraud should take steps to immediately document their observations; the illicit activity, the players, any potential witnesses, and any documentation or programs that were used to perpetuate the fraud. At this point, report the findings to the compliance department or, if your organization lacks a compliance department, to your manager. If you find that no action is taken to investigate or prevent the fraud, report your findings to the appropriate government body, be it the PCAOB or your state's Attorney General.

Historically, economic downturns are accompanied by an increase in fraudulent activity, as white-collar professionals feel the strain of financial uncertainty. There is no reason to assume that the current, COVID-induced economic decline will be any different. In fact, by May 28, 2020 the Internet Crime Complaint Center had received as many complaints as all of 2019 combined. (https://www.fbi.gov/news/testimony/covid-19-fraud-law-enforcements-response-to-those-exploiting-the-pandemic)

The following are some weak signals that may indicate fraud in a large organization.

large errors can lead to fraud," she said, "and firms that do not emphasize controls are likely to foster an environment that lacks integrity." Selevan specifies that companies should focus on dual control of all transactions, reconciliations of balance sheet accounts, and review of all accounting transactions.

In order to achieve strong controls, it is important to invest in accounting staff. This is true even for companies that are not publicly-traded, where annual audits are not required by law. "Companies that fail to do so," Selevan states, "create an atmosphere in which fraud can flourish. In this type of environment, management often avoids taking ownership of breakdowns in controls and operations."

Spot potential fraud by taking a hard look at the tone at the top.

Improper Incentives

Selevan suggests being especially wary of organizations where executive compensation is tied to performance. "When bonuses are based on performance," Selevan explains, "there is an incentive for management to manipulate reporting." Selevan elaborated that, while many companies tie compensation to performance, it should be regarded as an audit risk.

Selevan once worked for an organization where this exact scenario occurred. "A member of the management team was concerned that a large account receivables write-off would affect his bonus. The manager instructed me to increase the allowance account without hitting the income statement." Selevan refused to comply with his instructions and explained that the auditors would detect the discrepancy when they performed the allowance roll-over test. Selevan's manager relented, and the fraud was not committed.

Watch out for a poor incentive structure. It may be a weak signal of fraud.

Misreported Cash Flow

By way of example, Schervish explained that this phenomenon manifested itself at both Enron and WorldCom, two egregious perpetrators of financial reporting fraud.

Schervish also looks out for flattening or declining revenue that coincides with an upward operating cash flow trend. "An instance like this might be an indication that the company is overstating its reported operating cash flow," Schervish said. "Sometimes companies misrepresent their operating cash flow by improperly moving financial activity from the investing or financing cash flow buckets."

Generally speaking, revenue and cash flow should trend in a similar direction over a long period of time. Divergence may be a sign of fraud.

Siloed Operations

Rob Weston is a partner at Heimdal Satellite Technologies in London, UK, a company that leverages data analytics to root out fraud. Weston participated in the Madoff investigation, as well as investigations of major frauds at UBS and on England's foreign exchange. "I've found that one of the strongest indicators of fraud," states Weston, "is when departments are siloed within an organization."

Weston points to the case of Kweku Adoboli, an investment manager at Swiss banking giant UBS. In 2008, Adoboli began using the bank's money to make unauthorized trades, reported the *International Business Times* (https://www.ibtimes.co.uk/ubs-banker-kweku-adoboli-fraud-billions-384397). Adoboli hid his activities by entering false information into his computer at work. He blew past the bank's per-employee daily trading limit of $100 million and neglected to hedge his trades against risk. In 2011, Adoboli was arrested and charged with fraud and false accounting. His illicit activities cost UBS $2 billion (£1.4 billion), the largest unauthorized trading loss in British history.

“Adoboli raised every possible red flag,” Weston said. “He took data home on

Be wary of siloed operations – they could be vulnerable to fraud.

Certain companies, specifically organizations with the wrong tone at the top, improper incentives, confusing cash flow trends, and siloed departments, are more susceptible to fraud than others. Pick up on weak signals and take steps to combat fraud and minimize the financial fallout.

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