First Friday Fraud Facts+

August 7, 2015

The Idaho State Controller's Office distributes this newsletter as a cost-effective method of increasing awareness about ways to detect and prevent fraud, waste, and abuse in government.

Welcome to First Friday Fraud Facts+ (F4+). This edition will discuss financial statement fraud.

Financial Statement Fraud

Financial statement fraud makes up only about 7.6 percent of all fraud cases according to the 2012 ACFE Report to the nations. Although it makes up a small percentage, it is usually one of the most costly. The median loss is $1 million according to the 2012 Report. The most common ways financial statements are manipulated are by:[1]

- Improper Revenue Recognition
- Overstated assets
- Understated liabilities/expenses
- Misappropriation of assets

A majority of financial fraud committed is through improper revenue recognition. Some of the most common ways to do this are:[2]

- Sham sales – Record fictitious sales.
- Premature revenues – This usually refers to recording sales after goods are ordered but prior to shipping.
- Conditional sales – The transactions are recorded as revenues even though the sales involve unresolved contingencies or terms.
- Improper cutoff of sales – Accounting records are held open beyond the balance sheet date so sales in subsequent periods are recorded in the previous period.
- Unauthorized shipments – Revenues are overstated by shipping goods the customer never ordered
- Consignment sales – Revenues are recorded for consignment shipments of goods for customers to consider on a trial basis.

Questions or Comments:

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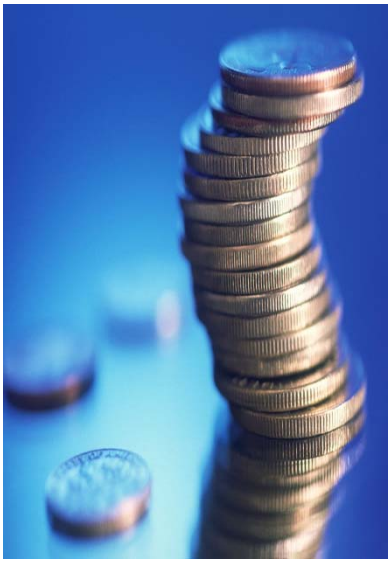

Governmental agencies should be aware of the potential for financial statement fraud by entities bidding for governmental contracts. Agencies may consider reviewing the financial statements and making necessary inquiries of bidding contractors or vendors to test for financial statement fraud. The Idaho Department of Administration has issued instructions which explain the state's right to request specific information, including financial statements, from vendors. The instructions can be found at the following website:

http://purchasing.idaho.gov/terms_and_conditions.html

FRAUD Case

Charles R. Kokesh was charged for misappropriating $45 million from four commission-registered business development companies (BDCs), which he formed. He did this through use of two Commission-Registered investment-advisor firms that controlled and provided investment advice to the BDCs. Kokesh owned 95 percent of one of the investment companies and the second was a wholly-owned subsidiary of the first (these will be referred to as Kokesh Advisors).

Each BDC was governed by a limited partnership agreement that served as the advisory agreement between the BDCs and Kokesh Advisors. In these agreements Kokesh Advisors were guaranteed management fees of six percent of capital investments the first year, four percent the second year, and two percent in years three-five. In the sixth year advisors would receive a management fee of .25 percent of the fair value of the BDC's assets, as well as a 20 percent performance fee based on the portfolio gains of the BDC. These advisory agreements prohibited Kokesh Advisors from receiving reimbursements for rent, salaries, and fringe benefits incurred or allocated to any controlling person (any person who performs the functions of managing general partners or their affiliates).

From the years 1995-2000 the four BDCs reimbursed the controlling persons $15 million for rent, salaries, and fringe benefits, which was in direct violation of the agreement.

Another aspect of the advisory agreement was the 99 percent of any distribution to investors and 1 percent to Kokesh Advisors, unless there were tax liabilities associated with the sale of BDC assets. In the year 2000 Kokesh Advisors paid the BDCs $6 million in distributions without corresponding distributions to investors, and there were no justifiable tax liabilities for the payments to be made.

These phony payments caused a negative amount to appear in the Kokesh Advisors' Capital account, and the BDCs failed to disclose the negative amount constituted debt owed by parties related to the BDCs.

As a result of this case, Kokesh was ordered to give up the amount obtained illegally plus a prejudgment interest on this amount. In addition, he must pay civil monetary penalties in an amount deemed appropriate by the court. He was also ordered to pay all equitable, ancillary, and other relief deemed proper by the court.[3]

[1] Case Studies in Financial Statement Fraud http://www.fraudconference.com/uploadedFiles/Fraud_Conference/Content/Course-Materials/presentations/23rd/ppt/5I-Gerry-Zack.pdf accessed January 21, 2015

[2] United States: Recognizing Financial Statement Fraud Red Flags http://www.mondaq.com/unitedstates/x/56058/White+Collar+Crime+Fraud/Recognizing+Financial+Statement+Fraud+Red+Flags accessed January 21, 2015

[3] Securities and Exchange Commission v. Charles R. Kokesh http://www.sec.gov/litigation/complaints/2009/comp21264.pdf accessed April 3, 2015