
BRIBERY IN INTERNATIONAL BUSINESS TRANSACTIONS



Association of Certified Fraud Examiners

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IV. CONCEALING CORRUPTION: MONEY LAUNDERING SCHEMES

Introduction

A bribe is essentially a corrupt transaction in which some form of benefit is either paid or offered to purchase the influence of the recipient. As with other forms of corruption, bribery is generally conducted covertly to avoid detection. Thus, while any benefit may qualify as a bribe, the most common payments and offers involved in bribery schemes are those that obscure the nature of the underlying act. In addition, a system of money laundering may be employed to further conceal acts of bribery.

The international effort to combat money laundering has increased greatly in recent years due to several factors. Governments and international organizations recognize the obvious link between corruption and money laundering. The large amounts of money generated by embezzlement, extortion, bribery, and other corrupt behavior must be disguised, just as the proceeds of other forms of crime. The expanding scope of the anti-corruption movement has thus targeted money laundering as a threat to financial stability and good governance. In addition, money laundering schemes have serious implications for terrorist activities. Although terrorist groups generally do not seek financial gain from their operations, they do require funding. While some of this money comes from illegal activity, a substantial portion is contributed. The need to implement safeguards and measures to prevent misuse of financial institutions and cut off avenues for terrorist funding has significantly bolstered the campaign against money laundering. Finally, new technologies and electronic fund transfers have created new vulnerabilities. Governments have responded with stricter countermeasures that take into consideration the modern techniques used to launder money.

This chapter describes the most common forms of corrupt payments involved in bribery schemes and how the money laundering process works. An overview of the international response to money laundering follows, which focuses specifically on the work of the Financial Action Task Force. In addition, this chapter includes three case studies and a set of indicators to identify and avoid the threats posed by money laundering. It concludes with a set of review questions.

The Money Laundering Process

Money laundering is generally accomplished in three stages: (1) placement, (2) layering, and (3) integration.

Placement

Placement of funds into a financial institution is the initial step in the process. It is at this stage that legislation has been developed to prevent launderers from depositing or converting large amounts of

cash at financial institutions or taking cash out of the country. Money laundering schemes are most often detected at this stage.

Placement can take any number of forms. If the money launderer has a large amount of cash, they can move the money out of the country in a suitcase and deposit it in an offshore bank. Another choice is to structure transactions, where a deposit or other transfer is made using a method that is specifically designed to avoid regulatory reporting requirements or an institution's internal controls. Many countries require financial institutions to report all currency transactions above a certain threshold (e.g., more than \$10,000) to the government. Consequently, the most common type of illegal structuring scheme in the money laundering context is *smurfing*, where the launderer breaks up the illicit money into smaller amounts and deposits it into bank accounts or purchases cashier's checks, traveler's checks, or money orders. A sophisticated smurfing operation might involve hundreds of bank accounts in dozens of cities.

Layering

If the placement of the initial funds goes undetected, financial transactions can be designed in complex patterns to prevent detection. This stage of the process is referred to as layering, and it represents the most difficult area of detection. Once the funds have been deposited into a financial institution, a launderer can move the funds around by using layers of financial transactions designed to confuse the audit trail. The money can even be transported out of the country through wire transfers. Often, launderers take advantage of jurisdictions known for their lack of cooperation with foreign courts, investigators, and law enforcement agencies. If a launderer moves funds through several such jurisdictions, tracing the destination can be burdensome.

Integration

The final stage in the laundering process is the integration of the money back into the economy in such a way as to make it appear to be a legitimate business transaction. This stage of the process is also difficult to detect; however, if the integration process creates a paper trail—such as deeds for real estate, invoices, loan documents, currency transaction reports (CTRs), or checks—and if there is cooperation from informants or foreign entities, then the chances of detection are improved.

A money laundering scheme cannot be successful until the paper trail is eliminated or made so complex that the flow of illegal income cannot be easily traced. The number of steps used to launder funds depends on how much distance the money launderer wishes to put between the illegally earned cash and the laundered asset into which it is converted. A greater number of steps increases the complexity of tracing the funds, but it also increases the length of the paper trail and the chance that the transaction will be reported.

The object of money laundering is not only to disguise the source of illegal funds, but also to convert large stores of currency into other assets. In some cases, illegal funds are spent on personal assets, such as homes, cars, jewelry, and furniture. However, the typical money launderer does not dispose of all their illegal currency in this manner; they want to have a certain amount of liquid reserves for spending. Keeping large bundles of cash is inefficient because they are difficult to hide and transport. Therefore, money launderers often convert substantial portions of their currency into negotiable instruments such as cashier's checks and money orders, which are routinely issued by financial institutions. Criminals prefer these negotiable instruments for two reasons. First, cashier's checks and money orders are bearer instruments, and the holder can use them or deposit them without having to prove the source of the funds. Second, they are "liquid" assets because the holder can use them immediately.

The following is an example of how a money laundering scheme operates.

EXAMPLE

Alberto Barrera, dubbed Papa Smurf by the federal agents investigating him, ran a rather sophisticated smurfing operation out of Miami involving bank accounts in cities all over the country. Barrera and his accomplices would fly to Phoenix, Denver, Omaha, Portland, and other cities. When they arrived, they would immediately travel to various banks. The scheme would begin with the purchase of cashier's checks and money orders in amounts less than \$10,000 (to avoid federal reporting requirements). This would be repeated several times at different banks. The "smurfs" would then travel to another city where some of the previously purchased check and money orders would be deposited in accounts controlled by Barrera. Then more purchases of cashier's checks and money orders would be made before the group traveled on to the next city. Once the money was converted or deposited, much of it was transferred to offshore banks.

Money Laundering Methods

There are many money laundering methods, and new techniques arise continuously. This makes keeping up with regulations and learning how to investigate such crimes an ongoing task. There are many common and emerging schemes of which fraud examiners should be aware.

Using a Front Business to Launder Funds

One of the most common methods of laundering funds is to filter the money through a seemingly legitimate business, otherwise known as a front business. A front business can be a very effective way to launder money for several reasons. It provides a safe place for organizing and managing criminal activity. A front doing legitimate business also provides cover for delivery and transportation related to illegal activity. In addition, such a business provides an unsuspecting venue for the comings and goings of large numbers of people. Moreover, expenses from illegal activity can be attributed to the legitimate enterprise, and the illegal revenues can be easily placed into the enterprise. One disadvantage (from the

launderer's perspective) to this scheme, however, is that launderers usually end up having to pay taxes on their illegal income.

The two methods most commonly used to hide assets or launder money through a front business are:

- Overstatement of reported revenues and expenses
- Depositing, but not recording, revenue

Overstating Reported Revenues and Expenses

Overstating revenues occurs when the money launderer records more income on the books of a business than is generated by that business. The fictitious revenue accounts for the illegal funds that are secretly inserted into the company.

The following example shows how the owner of Luxury Antiques uses overstatement of reported revenue to disguise money earned from other sources.

EXAMPLE

Luxury Antiques is a chain of antique stores with several locations within and around a major metropolitan center. It is locally owned. The bulk of its activity is in the sale of antique figurines. Luxury Antiques sells an average of two hundred pieces per month.

Customers are encouraged to pay in cash and, when they do so, are usually pleased when they receive a "special discount" (which can be as high as 25%) off the "official invoice price." The invoice the customer receives shows the full price rather than the discounted price. If a customer questions this practice, the store owner explains it is done for "competitive reasons."

Over the course of a year, Luxury Antiques sells 2,400 total figurines for an average "official invoice price" of \$4,000. This yields \$9,600,000 of recorded revenues. Actual cash received from customers falls short of that figure by 20%, for a total of \$7,680,000. The difference—\$1,920,000—is now available for laundering purposes. To take advantage of this situation, the owner simply deposits cash receipts of \$1,920,000 from his illicit sources as legitimate business income. The result is that \$1,920,000 has been successfully laundered.

Another way for Luxury Antiques to overstate reported revenues is to create fictitious sales with all the normal paperwork. If fifty fictitious sales are created each month at the average "official price" of \$4,000, an additional \$2,400,000 of laundered receipts are produced each year. The result is that \$2,400,000 of illicit funds can be disguised as legitimate business income. (Note that this method involves potentially more risk than the first because it involves completely fabricating all the elements of a sale rather than merely modifying one part of a normal sale.)

Overstating reported expenses helps counteract the key disadvantage of overstating revenues—taxes will be due on the reported income. However, because business expenses are tax deductible, additional tax liability incurred by inflated revenues can be reduced with fictitious business expenses. Therefore, if a company overstates its revenue, it will also want to overstate its expenses to offset its tax liability.

Another reason for overstating expenses is to siphon money out of the business to make payoffs, buy illegal goods, or invest in other criminal ventures. In practical terms, the method strongly resembles the more familiar practice of “padding” expense accounts. Among some of the commonly used schemes are “payments” for supplies never received, “fees” to fictitious consultants, and “salaries” for nonexistent employees. The possibilities for fraudulent payments are limited only by the imagination.

Overstating expenses can be accomplished using various methods. Return to the hypothetical business, Luxury Antiques, and look at three strategies employed by the store’s owner to inflate expenses and make the laundered cash available for criminal activity:

- Fictitious employees
- Fictitious fees
- Inflated invoices

In the following example, the owner of Luxury Antiques uses fictitious employees to inflate expenses.

EXAMPLE

Luxury Antiques has six salespeople and two assistant sales managers on the payroll. All eight employees are fictitious. Their “pay,” as well as sales commissions “paid” to the fictitious sales managers, represents an annual expense inflation of \$500,000. Luxury Antiques’ owner does not have to pay taxes on this \$500,000 and can take that amount of cash out of the business and put it into his own pocket.

In the following example, the owner of Luxury Antiques uses fictitious fees to inflate expenses.

EXAMPLE

Luxury Antiques has lawyers and consultants on “retainer” for a total of \$600,000 per year. They perform little or no business work, but they do submit invoices for fees on expensive stationery and with suitably vague descriptions of their activities. Once again, the money paid out is not taxed and can be put to illicit purposes.

In the following examples, the owner of Luxury Antiques uses inflated invoices to amplify expenses.

EXAMPLE

Luxury Antiques makes purchases from a supplier, who agrees to inflate invoices by 25%. The supplier then gives back four-fifths of the inflated amount, keeping the other one-fifth. On \$500,000 of actual purchases per year, Luxury Antiques reports expenses of \$625,000—an inflation of \$125,000.

EXAMPLE

A Luxury Antiques supplier, Import Associates, which provides 40% of the antiques sold by Luxury Antiques, sells figurines to Luxury Antiques in lots consisting of 150 to 200 pieces. The individual prices and the exact number of figurines in each lot are vaguely described in these “wholesale” bills of sale. Because of its long association with Import Associates, Luxury Antiques can arrange for the invoices to be inflated by an average of 30%. This gains Luxury Antiques about \$580,000 per year in inflated expenses (assuming 960 figurines at an average real cost of \$2,000 = \$1,920,000). By inflating the invoices by 30%, the invoice price reflects a price of about \$2,500,000, the difference representing laundered expenses.

Detecting money laundering that involves both overstated revenues and expenses can be difficult. When artificial price inflation is applied in moderate percentages to goods and services whose market value is difficult to establish (e.g., artwork, used cars, consulting fees, advertising expenses, etc.), detection is exceedingly difficult without inside information. On the other hand, complete fabrication of transactions or ghost employees is somewhat easier to spot.

Depositing, But Not Recording, Revenue

In one of the most common schemes at the local level, launderers “park” illicit cash in the company’s bank account rather than disguising it as revenue. These funds are not recorded like the money that flows into and out of a business as revenues and expenses. Like a loan, this excess cash represents the proceeds of a transaction that is handled outside of the business’s daily activity. Also, like a loan, it appears on a company’s statement of financial position, which includes both assets and liabilities.

EXAMPLE

Each month, an extra \$360,000 is deposited in Luxury Antiques’ bank account. To offset the entry, sales that are either fictitious or marked-up are credited for the laundered cash.

EXAMPLE

ABC Used Cars deposits an additional \$30,000 per month in its account although there are no recorded sales for this amount. At the end of the year, the company has an extra \$360,000 in cash in its account.

This type of scheme can be detected by examining the revenue records of the business. Every legitimate asset in a company's possession has come from somewhere—if not from revenues then from a limited number of other credible alternatives. The basic alternative sources include loans, sale of property or equipment, and capital investments from shareholders. All these transactions require significant documentary evidence, which the examiner should seek out to explain any suspicious infusion of cash into a suspect business.

Favorite Businesses for Hiding or Laundering Money

In general terms, the businesses chosen for money laundering possess one or more of the following characteristics:

- *Revenue:* Often, businesses chosen for money laundering are ones with a revenue base that is difficult to measure. Generally, revenue is difficult to measure in businesses with revenue from cash transactions with a highly variable amount per customer. In such businesses, extra money can be brought into the business and disguised as revenue.
- *Expense:* Front businesses often have variable expenses that are difficult to measure. With such businesses, launderers can extract money without raising undue suspicion.
- *History:* Many businesses used to launder money have historical ties either with the ethnic base of a specific criminal group or with other parts of an industry—either suppliers or customers.

BARS, RESTAURANTS, AND NIGHTCLUBS

Bars, restaurants, and nightclubs are commonly used to front money laundering operations for several reasons. They charge relatively high prices, and customers vary widely in their purchases. Sales are generally in cash, and it is difficult to match the cost of providing food, liquor, and entertainment with the revenues they produce. Moreover, the range of goods and services these types of businesses provide is relatively broad.

Fast-food restaurants are also frequently used as a front for money laundering operations, although they lack many of the attractive features of other types of restaurants and bars. Fast-food restaurants are cash businesses. Although they tend to charge lower prices than other types of restaurants, most of their sales are made in cash, and expenses can be easily inflated. Thus, a red flag of front businesses is observing a low amount of business, despite the business's books showing a relatively high income for that period.

VENDING MACHINE OPERATIONS AND MOVIE THEATERS

Vending machine operations also possess many characteristics favorable to a money laundering operation. They have a highly variable and difficult to measure volume of cash receipts, and in large operations, there is a fair amount of flexibility with various transportation, installation, and promotion expenses, providing cover for the withdrawal of laundered funds.

WHOLESALE DISTRIBUTIONS

Wholesale distribution businesses have historically been a prominent part of money laundering. Depending on the competitive environment, wholesale distributions do not normally require the same managerial skills necessary to operate a high-volume retail business. Wholesale distribution is attractive for money laundering because it is well embedded in a community's economic fabric.

From the revenue perspective, wholesale operations are somewhat less ideal for launderers because invoicing, rather than cash transactions, are typical. Even so, a diverse product line and falsified invoices provide a substantial amount of flexibility. More important, the industry is ideal for money laundering from the standpoint of expenses. The activities required to run this kind of business are so diverse and difficult to measure that expenses are easy to inflate. A wholesale business's buildings, warehouses, transportation fleet, and contact with retail establishments are all attractive factors.

The Real Estate Industry

Money launderers often use the real estate industry to launder illicitly obtained money. The real estate industry is attractive to money launderers for various reasons. For one thing, the vast array of financial transactions linked to real estate provides money launderers with an exceptional range of options for abusing these procedures to launder and use illegally obtained funds. For another thing, real estate transactions often involve multiple parties (such as brokers, agents, and appraisers), which can obscure the source of investment funds and the identity of the true owner. Finally, money launderers may earn additional profits from introducing illicit funds into the real estate industry, especially in vibrant real estate markets.

Although there are a vast number of methods to launder money in the real estate industry, there are a few common schemes that warrant identification and discussion, including:

- Loan back schemes
- Back-to-back loan schemes
- Shell entities
- Appraisal fraud
- Monetary instruments
- Mortgage schemes
- Indirect investments in the real estate industry

Loan Back Schemes

Money launderers often use loan back schemes to finance the purchase of properties directly or indirectly through purchasing shares in property investment funds. In a typical loan back scheme, money launderers deposit illicit funds in an overseas entity that they own, and then the entity loans the funds

back to the launderers. The purpose of the loan is to make the money source appear legitimate and to conceal the parties' identities or the nature of the financial transactions associated with the loans.

Back-to-Back Loan Schemes

As with loan back schemes, money launderers often purchase real property using illicit assets (or receive real property because of fraud). In a back-to-back loan scheme, a money launderer obtains a loan by presenting collateral that originated from illicit funds to a financial institution. Like the loan back scheme, this technique gives the loaned money the appearance of a genuine loan.

Shell Entities

Money launderers often use shell entities (which are discussed in more detail below) to purchase real estate. Generally defined, *shell entities* are organizations without active business or significant assets, and they can take the form of limited liability companies, trusts, business trusts, and corporations. Because there is a lack of transparency in the formation of shell entities, money launderers often use them to hide the identity of the true owner, the source of the money, or the destination of the money.

Appraisal Fraud

Appraisal fraud is often associated with money laundering schemes. Money launderers may purchase properties to launder money or may use illicit funds to service the interest on the debts. Such schemes can conceal the identity of the property owners and the true origin of the funds used in the transaction.

Appraisal fraud occurs where appraisers fail to accurately evaluate the property, or when the appraiser deliberately becomes party to a scheme to defraud the lender, the borrower, or both. A common technique is the overvaluation or undervaluation of property, which consists of buying or selling property at a price above or below its market value. In addition to manipulating appraisals, money launderers also overvalue property through a series of subsequent sales, each time at a higher price, which tend to conceal the true purposes of the transactions.

Schemes Involving Monetary Instruments

In many instances, money launderers purchase, build, or renovate property with cash, wire transfers, or other payable-through accounts. This allows the integration of large sums of illicit money into legal financial systems. Later, if sold, it is difficult to relate the transaction to any criminal activity, and the transaction therefore successfully conceals the true origin of the illicit funds and their ownership.

Mortgage Schemes

Often, money launderers use illicit funds to pay the interest or repay the principal on mortgage loans, and, in so doing, the illicit income is converted into seemingly legitimate profits when the property is

sold. Mortgage schemes also involve undervaluation and overvaluation of property. For example, in a common undervaluation scheme, a money launderer undervalues the purchase price of property, obtains a mortgage loan for the undervalued amount, uses the loan to pay for the undervalued price, and pays the excess amount under the table with illicit funds.

Indirect Investments in the Real Estate Industry

In the real estate industry, indirect investments, which are those in which the investor has no direct control over the assets or investment vehicle, offer opportunities to conceal an investor's identification and monetary sources, primarily because multiple parties are involved with the process.

Emerging Payment Methods and Schemes

The technological landscape behind conducting transactions is constantly changing, in large part to make payments faster and more convenient. This discussion examines some emerging payment technologies used to launder money, and it includes a discussion of methods that have existed for a while but are in the process of becoming prominent concerns.

ATMs

Often, launderers use automatic teller machines (ATMs) to launder money. ATMs are relatively inexpensive, and money launderers purchase the machines and place them either in establishments they control or in legitimate businesses. The machines work the same as other ATM machines, and all transactions are legitimate. The money launderer fills the machine with cash from illegal activities. The customer uses the machine and never realizes the cash's source.

The ATM banking system debits the cardholder's account and credits the ATM owner's bank account. At the end of the month, the launderer receives a bank statement showing funds being deposited from a legitimate financial institution.

This option is attractive for money launderers because there are currently few jurisdictions that regulate the use and operation of privately-owned ATMs. There is usually no requirement to check the backgrounds of purchasers of the machines, and there are no mandatory reporting procedures and no rules for maintaining ATM sales records.

Prepaid Items

Many businesses offer customers the ability to prepay for products and services. This practice is beneficial to customers because it gives them the ability to give these items as gifts and provides convenience. Moreover, prepaid items are great for businesses. They generate cash flow for items that

have not been purchased yet, and some prepaid purchases are never redeemed, resulting in a windfall. Perhaps most important for large companies, prepaid items can open international markets.

While mainly used for legitimate business, prepaid items can also be used by money launderers to hide and transfer assets.

TYPES OF PREPAID ITEMS

Broadly speaking, prepaid items are goods and services that are paid in advance of their actual purchase. Some examples of prepaid items with potential for money laundering include:

- Merchant gift cards
- Prepaid debit cards (as opposed to a standard checking/debit account)
- Payroll cards
- Prepaid mobile phones
- Mass transit cards
- Gaming and lottery cards

VULNERABILITIES OF PREPAID ITEMS

The most attractive aspect of prepaid items to money launderers is that issuers of these items and the people who use them are under relatively fewer regulatory restrictions than traditional financial institutions and banking customers, and consequently prepaid items offer a greater degree of potential anonymity than basic credit or debit cards.

Additionally, traditional financial institutions are required to perform a certain minimum of due diligence on their customers, but for prepaid issuers this burden is substantially less.

Additionally, prepaid items can be transported abroad with relative ease.

USES OF PREPAID ITEMS IN LAUNDERING SCHEMES

Given the vulnerabilities of prepaid items, there are various ways that criminals can use them in laundering schemes.

As a means of placing illicit proceeds, launderers could initially load the funds in prepaid items like open loop cards and gift cards, which are easy to obtain. Although there are maximum limits to the amount that a person can load onto a rechargeable prepaid item each day, as well as total maximum account values imposed by the issuer, criminals could obtain multiple prepaid cards and add funds to them over time. The benefit of this use would be a less bulky, less suspicious, and more transportable type of asset.