U.S. Department of Justice
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Bureau of Justice Assistance

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ASSET FORFEITURE

Uncovering Assets Laundered through a Business

7th in a series

POLICE EXECUTIVE RESEARCH FORUM

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Uncovering Assets Laundered through a Business

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Washington, D.C. 20531

Dear Colleague:

Illicit drug traffic continues to flourish in every part of the country. The cash received by the traffickers is often converted to assets that can be used by drug dealers in ways that suit their individual tastes. Since 1981, federal authorities have increased their attack on these assets through both criminal and civil forfeiture proceedings with remarkable success. The recent passage and use of state asset forfeiture laws offers an excellent means for state and local jurisdictions to emulate the federal success.

The Bureau of Justice Assistance (BJA), in the Office of Justice Programs, has funded a nationally focused technical assistance and training program to help state and local jurisdictions facilitate broader use of such laws. BJA selected the Police Executive Research Forum to develop and administer this program because of its history of involvement in practical, problem-oriented research to improve police operations and the Forum's central role in developing training materials for use by police agencies and chief executives.

As part of this project, the Forum has contracted with experts in the area of asset forfeiture and financial investigations to prepare a series of short manuals dealing with different concerns in the area of asset forfeiture. We hope these manuals help meet the rapidly unfolding needs of the law enforcement community as more and more agencies apply their own forfeiture laws and strive to learn from the successes and problems of their peers.

I welcome hearing your comments about this program. We have structured this project so that most requests for information or assistance can be handled through the Forum staff in Washington, D.C., by calling 202/466-7820.

Sincerely yours,

Charles P. Smith, Director
Bureau of Justice Assistance

Acknowledgments

PERF commissioned this paper to help investigators approach a contemporary issue in financial crime more effectively. We decided to start with the basics—that the processes of laundering illegal funds through businesses are not widely understood or easily simplified. That soon became a real challenge in a BJA project devoted to training and technical assistance. However, we were fortunate in finding an author willing to accept this challenge and in enlisting the help of several resource experts to review and comment on the working draft.

The experts were extremely generous with their time and informed the effort with many constructive suggestions. In the end, we felt that we achieved a difficult balance between clarity and complexity. We are particularly grateful to Richard A. Nossen, a financial investigative consultant in Richmond, Virginia; and Charles Morley, president of The Morley Group, an investigative resource firm in Arlington, Virginia.

We also appreciate the technical review performed by staff of the Criminal Division, U. S. Department of Justice, Washington, and especially Judi Friedman of that office. Also, the patience and perseverence of our BJA Program Manager, Fred Wm. Becker, deserve our grateful acknowledgment.

The Police Executive Research Forum

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Uncovering Assets Laundered through a Legitimate Business

Introduction

This paper attempts to shed some light on the use of local businesses as vehicles for disguising the proceeds of criminal transactions—one facet of a larger process known as money laundering. It focuses specifically on local, business-related money laundering. The paper does not deal with other money laundering mechanisms such as those carried on through banks, brokerage houses, real estate investment, and gambling casinos, or those involving so-called offshore and shell corporations.[1]

The discussion of local money laundering is fairly theoretical, for two reasons:

- First, although the type of money laundering activity described in the paper is thought to be common, little is known about its actual extent. Nor is there much known about which methods are most widely used. Practical, case-related examples have come about as byproducts of regular investigations into narcotics trafficking and money laundering through financial institutions. As a result, comprehensive, concrete data are rare.
- Second, the kinds of activity included under the heading of business are enormously diverse. Even though the operations of any one business may not be complex, each business has its own peculiar structure, documentation, and pattern of activity. A bookstore and a beauty parlor, for example, share certain characteristics, but it is difficult to discuss them together without some kind of overall framework.

Hence, this type of publication cannot provide the kind of detailed guidance that has been provided in studies tracing financial transactions through the highly regulated banking system or investigative guides to uncovering ownerships of real estate or shell corporations.

This paper has four sections:

- "The 'Universe' of Money Laundering" puts into perspective the concept faced with rational alternatives. It also indicates the chief differences between money laundering through financial institutions (which is more common and involves more dollars) and money laundering through otherwise legitimate business activities.

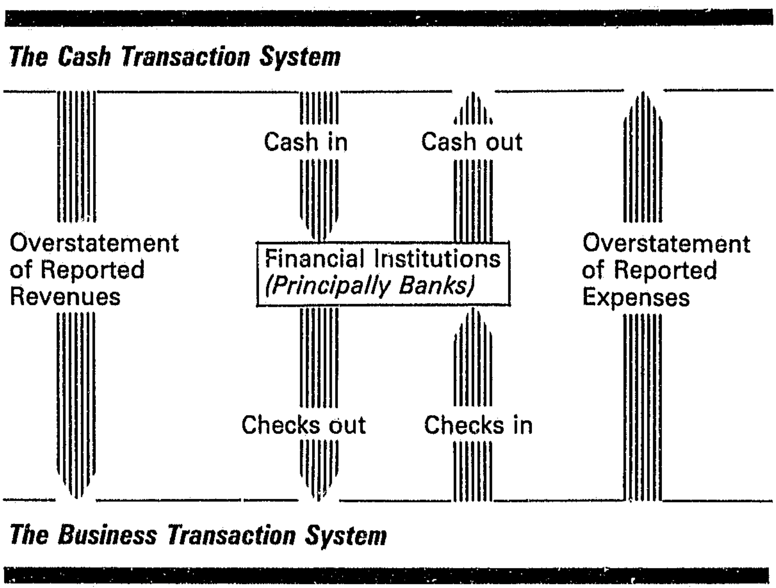
- "The Mechanism of Money Laundering" describes three possible mechanisms of money laundering in a typical business. A hypothetical company (a used-car dealership) illustrates each mechanism, followed by examples of methods generally used by auditors to uncover the given mechanism.
- "Money Laundering in Local Businesses" discusses the use of specific kinds of enterprises for money laundering from two different perspectives: (a) the kinds of businesses that so far have been discussed as vehicles for money laundering, and (b) the *suitability* of various businesses for money laundering, based on certain intrinsic characteristics of those businesses.
- "Enforcement Strategies" suggests how information in the above section might be applied by local law enforcement officials.

The "Universe" of Money Laundering

The generally accepted definition of money laundering is that given in the *Interim Report of the President's Commission on Organized Crime* as "the process by which one conceals the existence, illegal source, or illegal application of income and then disguises that income to make it appear legitimate."[2] It is a good definition, but it does not address the underlying mechanisms and schemes of money laundering. Nor does it help by suggesting law enforcement strategies. Money laundering might be described more usefully as the conversion of money from a "Cash Transaction System" into a "Business Transaction System." Transfers also occur in the opposite direction—from the Business to the Cash Transactions Systems, for example, when business assets are liquidated to provide working capital.

As the diagram on page 9 indicates, the Cash Transaction System and the Business Transaction System run parallel for *all* types of activities, legitimate and illegitimate. Each system has its own characteristics with advantages and disadvantages for each given activity.

The Money Laundering "Universe"



The Cash Transaction System

- As its name implies, all transactions in the Cash Transaction System are carried out in cash.
- Cash is fungible, which means that there is nothing to differentiate one dollar bill from another, as to either ownership or source.

The positive and negative aspects of all-cash transaction systems are summarized below:

Advantages

- Everyone can come up with cash to pay for illicit goods or services.
- Lack of records makes it difficult to connect a person with

Disadvantages

- Logistically, large amounts of cash are difficult to handle and transport.
- In large amounts, cash is a risky medium. Loss, theft, and

Advantages

criminal activity or with purchase of illicit goods or services.

- Unreported revenues are not taxed.

Disadvantages

discovery by authorities are constant worries.

- In large amounts, cash is suspicious and calls attention to those who hoard or use it.
- Lack of records makes it difficult to prevent pilferage by "employees" or "distributors."
- Certain assets cannot be acquired for cash without an extensive inquiry into its source.

The Business Transaction System

As defined here, the Business Transaction System relies on non-cash instruments, such as checks, for effecting transactions. All transactions in the Business Transaction System are unique and pass through publicly regulated institutions, such as banks. Each has a specified source, destination, and date. All transactions in the Business Transaction System generate records. These records indicate the source and the destination of transactions and are subject to review by federal, state and sometimes local governments.

Advantages

- There is great efficiency and security in the transfer of funds.
- Business expenses are tax deductible.
- Assets are protected by public institutions (banks), police, Securities and Exchange Commission, and state regulatory bodies.
- Losses owing to pilferage are controllable.
- The entire range of business is

Disadvantages

- Taxes must be paid on reported revenues.
- Every transaction has a source and destination, either of which can lead authorities to criminal activity.
- Business records are subject to review by all levels of government.
- Falsification of records to reduce the risk of detection is itself a criminal act and can lead to

Advantages	*Disadvantages*
open, including legitimate investment in real estate, securities, etc.	prosecution even without proof of other criminal activity.
• A business, being a legitimate enterprise, is a valuable base of operations and a potential source of concealment for criminal activities.	
• Involvement in the Business Transaction System permits acquisition of community standing and influence which provides extra camouflage for illicit operations.	

The most important conclusion to be drawn from these analyses is that there are powerful motivations, both positive and negative, for criminals to carry out some part of their activities in *both* systems. This has great significance for law enforcement, because it implies that virtually all criminals must move from one system to the other to carry out their activity. If it were feasible to remain entirely in one system only, criminals would have strong protection from law enforcement scrutiny. But because illegal enterprises are more or less obligated to move between the two systems, they are extremely vulnerable when they switch from one to the other—and generate paper trails.

Criminals substantially increase their risk of apprehension when they engage in activities such as . . .

- inflating reported sales volume to explain extra cash;
- depositing excess funds without any business transactions to explain them;
- purchasing or selling assets (equipment, real estate) at inflated prices;
- inflating expenses to free cash for illegal activity; or
- writing checks to accomplices for bogus services (e.g., consulting, fictional employees).

For this reason, knowledge of money laundering techniques has great promise as a tool for law enforcement.

Knowing the techniques for business-oriented money laundering not only can provide immediate information about some of the most vulnerable points of a criminal operation, but can also be the source of admissible evidence. Additionally, in most states, this knowledge can open the door to asset seizures and forfeitures.

The Mechanism of Money Laundering

How is the transfer from one system to the other carried out? The problem is to disguise liquid economic assets (i.e., cash that is *received* from either the sale or the production of illegal goods and services) as part of a normal economic cycle of a legitimate business.[3] This disguising process, like using a counterfeit ticket to get into a sporting event, involves getting past a "point of entry." In the case of a business, the point of entry consists of the bogus transaction and its accompanying documentation (the counterfeit ticket). That documentation may explain either the presence of extra cash in the business or the expenditure of business assets for nonbusiness-related purposes.

There are three ways that are commonly used to disguise the entry or investment of money in a business. The three methods, which are discussed in further detail below, are:

- Overstatement of reported revenues - recording more income on the books of a business than is actually generated by business activity.
- Overstatement of reported expenses - recording more expenses on the books of a business than what is actually spent to carry out business-related activity.
- Depositing cash and expenses - no effort is made to completely disguise the presence of excess cash or its expenditure.

The first two methods collectively are also known as "income statement laundering," and the third is "balance sheet laundering."

To help understand the various methods of business money laundering and the strategies used to detect them, we will use the example of a hypothetical business—Fair 'n' Square Motors, an automobile dealership. (Fair 'n' Square's financial statements can be found on page 21).

Overstatement of Reported Revenue

Overstatement of reported revenue is a way of disguising additional money from nonbusiness sources by adding it to the sales records of a business. Fair 'n' Square Motors is located in a suburban community, not far from a major metropolitan center. It is locally owned and has a small new car dealership, a concession from a foreign carmaker. The bulk of its activity, however, is in the sale of used cars of all makes and in repairs and servicing. Fair 'n' Square sells an average of 20 used cars per month.

Customers are encouraged to pay cash for their cars, and, when they do so, are usually pleased to see the size of the "special discount" (which can be as high as 25 percent) they receive from the "official invoice price." There is no mention of the discount on the invoice, however, for "competitive reasons." Over the course of a year, Fair 'n' Square's sale of 240 cars at an average "official invoice price" of $4000 yields $960,000 of recorded revenues. Actual cash received from customers falls short of that figure by 20 percent for a total of $768,000. The difference, $192,000, has been successfully laundered—at least until you discover it! The $192,000 of cash receipts from various illicit sources can be permanently disguised as legitimate business income simply by depositing it in the company's bank account, and commingling it with normal business receipts.

Another way for Fair 'n' Square to overstate reported revenues would be to create fictitious sales with all the normal paperwork. Say, for instance, that five fictitious sales were created per month, at the average "official invoice price" of $4000. This would add an additional $240,000 of laundered receipts, allowing that much cash to be disguised as legitimate business income. (Note that this method involves potentially more risk than the first, because it involves completely fabricating all elements of a sale rather than merely modifying one part of a normal sale.)

Overstatement of reported revenues does have one glaring disadvantage, however. Because the additional income is openly reported, it is fully taxable. Unless criminals want to pay much of their laundered proceeds in taxes, they need to find some way to reduce their increased tax liability.[4] This problem is most often resolved by resorting to the second "income statement" method of money laundering—overstatement of reported expenses.

Overstatement of Reported Expenses

This money laundering method nicely complements the practice of overstating reported revenues. First, because inflated expenses (just like real ones) are tax deductible, additional tax liability caused by inflated revenues can be reduced or eliminated. Second, cash can be siphoned back out of the business to make payoffs, buy new stocks of illicit goods, or invest in new criminal ventures. In practical terms, the method strongly resembles the more familiar practice of "padding" expense accounts. Here, however, money used for illicit purposes is disguised by inflating legitimate business expenses. Amounts can be "paid" for supplies never received, fictitious consultants can be given fees, and nonexistent employees can be paid on a regular basis. The possibilities are limited only by the imagination.[5]

To go back to our hypothetical business, Fair 'n' Square Motors, let's take a look at four strategies employed to inflate expenses and make laundered cash available for criminal activity:

- In the first strategy, Fair 'n' Square has three mechanics and an assistant sales manager on the payroll who have never existed. Their pay (and sales commissions in the case of the fictitious sales manager) represents an annual inflation of expenses of $100,000. This amount is available to avoid taxes and get an equivalent amount of cash back out of the business.

- In the second strategy, Fair 'n' Square has "lawyers" and "consultants" on retainer for a total of $200,000 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.
- In the third strategy, Fair 'n' Square purchases lubricants from a supplier who agrees to inflate invoices by 25 percent and to give back four-fifths of the inflated amount. On $50,000 of actual lubricant purchases per year, Fair 'n' Square reports expenses of $62,500—an inflation of $12,500.
- In the final example, XYZ Car Rentals, which provides 40 percent of the used cars sold by Fair 'n' Square, sells cars to Fair 'n' Square in lots of 15 to 20 cars at a time. Individual car prices and the exact number of cars involved are only vaguely described in these "wholesale" bills of sale. As a result of its long association with XYZ, Fair 'n' Square is able to arrange invoices inflated by an average of 30 percent, thus gaining about $58,000 per year in inflated expenses (96 cars at an average real cost of $2000 = $192,000. Thirty percent inflation gives an invoice price of $250,000. The difference represents laundered expense).

Income statement laundering (which includes overstatement of both revenues and expenses) can be difficult to detect. When artificial price inflation is applied in moderate percentages to goods and services whose market value is difficult to establish (e.g., used cars, consulting fees), detection without inside information is exceedingly difficult. Complete fabrication of transactions, on the other hand, or creation of "ghost" employees is somewhat easier to spot. We will examine why this is so in our discussion of detection methods.

Balance Sheet Laundering: Depositing Cash and Writing Checks in Excess of Reported Revenues and Expenses

In this money laundering technique (which is probably the most common at the local level), excess cash is not disguised as normal business revenue, but, rather, is "parked" in the company's bank account. This is certainly easy to do, and does not take too much imagination. This technique is called "balance sheet laundering" because it is independent of 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 everyday business activity. Also, like a loan, it appears on a company's "balance sheet," or statement of assets and liabilities.

Let's see how this method might work in the case of Fair 'n' Square Motors. Assume that, in addition to the amounts laundered by the "income statement" techniques, an additional $20,000 per month for which there are no recorded sales is deposited in Fair 'n' Square's bank account. Assume further that this $20,000 is allowed to accumulate over the course of a year. At the end of a year, there will be $240,000 in cash which is not explained by any recorded revenue.

Simply allowed to accumulate like this without any disguising documentation, the illicit receipts fall afoul of the ruthless logic of accounting. Every asset (including cash) in a company's possession must come from somewhere—if not from revenues, then from a quite limited number of possible alternatives. All of these alternative sources, to be credible, require significant documentary evidence. The basic ones are (a) loans; (b) sale of property or equipment; and (c) investments received from shareholders.

In the case of Fair 'n' Square Motors, when you compare its balance sheets (see page 21) for December 31, 1986 and December 31, 1987, you will see that they are quite different.[6] On December 31, 1986, assets are equal to liabilities and owners' equity. On December 31, 1987, although owners' equity has increased by the amount of reported revenue, there has been no other change to explain the additional cash, and the excess accumulation is readily evident.

The Challenge of Detection

Each of the above business-related money laundering techniques has its "Achilles' heel." Certified Public Accountants and government tax auditors have developed detection methods to deal with all of them. Some of these techniques are highly sophisticated and involve statistical sampling and expertly developed computer programs. But many of them are based on no more than shrewd common sense. These detection methods are not foolproof, but where they are applied with good judgment, they can be useful. One does not have to be a trained professional to understand how they work, although their practical application can be difficult, at least initially, for the non-accountant. The reasoning that underlies some of the most important methods is detailed below.

Detection of Income Statement Laundering

The classic way to test reported revenues and expenses to determine if they reflect reality is to compare them with an independent indicator of revenue or expense. For example, a movie theater with 100 seats that charges $4 a seat and shows three films daily has a maximum gross revenue of $36,000 per month (100 x 4 x 3 x 30). If its monthly revenues were reported as $50,000 per month, it would be obvious that $14,000 was coming from somewhere else. Such clear-cut and logical situations as this are relatively rare, but independent indicators exist everywhere. In many cases, surprisingly accurate tests of revenues and expenses can be generated from seemingly insignificant statistics.

For example, a common method employed by French tax authorities when auditing restaurant owners (who are notorious tax cheats) is to check their laundry bills (for the number of tablecloths cleaned) and their bakery bills (for the number of loaves of bread consumed). From this they make their own independent estimate of revenues (the average price of a meal does not vary much) and compare them with those reported. Obviously small variations do not constitute adequate proof of fraud, but large-scale fraud is extremely hard to hide from this kind of analysis.

Certain types of expenses are particularly amenable to this approach. For example, purchases of gasoline that are enough to keep a fleet of trucks running for 24 hours a day all year long would obviously be suspect, as would photocopy expenses three or four times greater than justified by the counter on the office photocopy machine. The existence of a "ghost" employee on the payroll can often be verified by reference to a host of other non-payroll sources of information (time cards; credit union records; and records of social security contributions, quarterly tax withholding payments, unemployment compensation insurance payments, etc.).

Detection in Action: Fair 'n' Square Motors

Let's see how some of these methods would work in the case of Fair 'n' Square, which launders money by inflating revenues on individual car sales and by creating fictitious car sales. In the first case, an auditor or investigator would compare the invoice prices for given makes and models of cars with the prices charged by competitors. If prices were significantly higher (about 25 percent in this case), there would be reason to suspect money laundering. Further evidence could be gathered by talking to customers who had bought the cars.

In the case of fictitious sales, car registrations could be checked against a sample of sales. If there were no motor vehicle registrations recorded for a significant number of cars, this would be an indication of fraudulent transactions. Proving that vehicles recorded as sold had never existed would be strong evidence of money laundering activity.

On the expense side of income statement money laundering, the creation of "ghost" personnel (three mechanics and a salesman) is similar to the fictitious car sales above. Proving that some employees who have been routinely paid have never existed, provides firm ground for substantiating allegations of money laundering. It is difficult to create, on paper, a truly convincing false automobile or fictitious person. This is because both would give rise to so many independent verifications of their existence if they were genuine. Covering up *all* these possibilities in anticipation of an investigation is highly unlikely.

More difficult, on the expense side, are the retainer fees for the "consultants." The sums shown in this example ($200,000) are plainly out of line with any reasonable need by a used-car dealership, but it is extremely difficult to get a firm estimate of the worth of vaguely defined services.

Also difficult, unless you have access to comprehensive shop records or other evidence, is uncovering the price inflation for the lubricants provided by a supplier. The supplier's records, however, might very well conflict with those of Fair 'n' Square. This would provide an additional avenue of approach in a full-fledged investigation.

The final example—purchases of used cars from XYZ Rentals—may be the most difficult of all to catch. In the case of large and regular wholesale transactions of this sort, it can take some doing to get a clear fix on either of the two essential elements, price and quantity. In a case like this, the investigator must use his/her imagination. If there is reliable information from informants that substantial money laundering has occurred in these transactions, it is not likely that they could long stand up to close scrutiny.

Important Factors in Detection of Income Statement Laundering

As can be seen from the examples, detection of income statement laundering is heavily dependent on (a) the quality of documentation and the accuracy of independent indicators of revenue and expense and (b) the extent of the variation from true, business-related activity.

Without solid documentary evidence, differences of 10-15 percent would normally be difficult to detect. A difference of 50 percent however (as might well be the in an unsophisticated local money laundering operation), would be easily disclosed.

Detection of Balance Sheet Laundering

In the example, money had simply been "parked" in Fair 'n' Square's bank account (see table on page 21), and left there to accumulate for a year. No attempt was made to create fictitious documents (such as a loan agreement) to justify the presence of the excess cash. The figure simply "popped out" at the auditor when a balance sheet was drawn up. Unfortunately, it is not so simple in the real world. Money goes in and out of the bank account, and documents *can* be created or altered to explain the presence of extra sums of cash.

The way to uncover balance sheet laundering is through a methodical and thorough investigation of the genuineness of the documents that support the various amounts on the balance sheet. Changes from the previous year, such as new loans or sales of equipment should be given particularly close scrutiny. Receipts and payments made during the year that are not related to revenue and expense can be traced to the balance sheet items to which they relate. Repayment of loan principal, for example, should be checked to see that it does not exceed the requirements of the underlying loan. The selecting process can be tedious, but, in the end, significant cash balances, receipts, or payments that are not related in some logical way to the company's assets and liabilities will come to light.

Money Laundering in Local Businesses

This section outlines the typical money laundering mechanism for a number of business activities that are often associated with criminal activity. Almost any business activity can be used for money laundering, depending on the sophistication and managerial talents of the persons involved. Generally, however, it can be said that businesses that are highly competitive or require substantial skill are less likely to attract direct criminal involvement (though passive investment of illegal proceeds cannot be ruled out). There are two reasons for this:

- It is difficult to run both a demanding business and a demanding criminal network at the same time.
- The potential losses from a high turnover, competitive commercial enterprise that is poorly run, are great.

FAIR 'N' SQUARE MOTORS Balance Sheet (Dollars in 000's)

	Dec. 31, 1986	*Dec. 31, 1987*
Assets		
Cash*	$ 200	$ 520
Accounts Receivable	350	350
Inventories	250	250
Fixed Assets:		
Land	50	50
Building and Equipment**	600	570
Total Assets	1,450	1,740
Liabilities & Equity		
Accounts Payable	150	150
Bank Loans	500	500
Owners' Equity	800	800
Total L&E	$1,450	$1,450

* December 1987 balance includes an unspent accumulation of $20,000/month from unrecorded outside sources.
** Net of Accumulated Depreciation.

FAIR 'N' SQUARE MOTORS Income Statement For the year ended December 31, 1987 (Dollars in 000's)

	With Money Laundering	*Without Money Laundering*
Sales		
New cars	$ 600	$ 600
Used cars	1,200	768
Service and miscellaneous	800	800
Total	2,600	2,168
Cost of Goods Sold	1,145	1,087
Gross Income	1,455	1,081
Expenses		
Payroll and commissions	800	700
Supplies	200	188
Rent	50	50
Telephone and utilities	50	50
Fees	200	-0-
Depreciation	30	30
Interest Expense	75	75
Total	1,405	1,093
NET INCOME	$ 50	$ (12)

Examples of businesses poorly suited to money laundering are supermarkets, discount stores, and sporting goods stores.

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

- *Revenue.* A revenue base that is difficult to measure, usually because most revenue comes from cash transactions with a highly variable amount per customer. This allows extra money to be brought into the business and disguised as revenue.
- *Expense.* Expenses which, by their nature, are difficult to measure, can serve legitimate and criminal activity simultaneously, without giving rise to undue suspicion. Such features include:
  (1) A safe place for organizing and managing criminal activity, where the comings and goings of large numbers of people will not arouse undue suspicion.
  (2) Activities, such as delivery and transportation, that can be for both legitimate and illegitimate activity but whose expenses can be entirely attributed to legitimate activity.
- *History.* Historical ties, either with the ethnic base of a particular criminal group or with other parts of the industry (suppliers or customers) that have traditionally served as a base for criminal activity. A good example of this is the well-documented Mafia infiltration of Pennsylvania pizza parlors from the point of olive oil distribution, through cheese manufacture and distribution, to final use of pizza retail outlets for money laundering and as a base for criminal activity.[7]

A word should be said here about the three types of business activity that are not covered in this paper: (a) financial institutions (banks, brokerage outlets), (b) real estate investment, and (c) legalized gambling establishments. All three are ideal for money laundering activities, but they are highly regulated and highly specialized. For these reasons, these activities pose significant jurisdictional problems and require specialized knowledge to approach them properly.[8] They are also somewhat less likely to represent major elements of criminal activity at the local level.

Bars, Restaurants, and Night Clubs

These are certainly the most common establishments for money laundering at the local level. They meet nearly all the requirements for an ideal penetration of the business economy.[9]

- *Revenues.* Restaurants, bars and nightclubs charge relatively high prices and customers vary widely in their consumption. Sales are also made in cash, and it is notoriously difficult to match the costs of providing food, liquor, and entertainment with the revenues they produce.
- *Expenses.* The range of goods and services which are a normal part of business are relatively broad, including salaries, food and drink, and vending and entertainment contracts.
- *Business Features.* Customers of these establishments seek entertainment and distraction. They can be ideal contact points for gambling, drugs and prostitution—criminal activities that are natural extensions of entertainment and distraction.
- *History.* Every ethnic group has its own restaurants and places of entertainment. These have served each group in turn as starting points for legitimate as well as criminal economic activity. Such establishments are also part of the "pipeline" for the placement of vending machines, an industry long associated with organized crime.

Fast Food Restaurants

Fast food restaurants have developed into a phenomenon in their own right. While lacking many of the attractive features of other restaurants or bars, they nonetheless offer a number of advantages, not the least of these being their novelty as fronts for criminal activity.

- *Revenue.* Fast food establishments are a cash business, but their offerings are more restricted and lower cost than traditional restaurants. It is still difficult, however, to detect inflation of receipts from outside sources.
- *Expenses.* Advantages are limited, although amounts for salaries and basic supplies can be inflated to allow money to be drawn out of the business.
- *Business Features.* These establishments can be convenient contact points for financial transactions. Less conspicuous than a street corner,

they permit a narcotics transaction to be disguised as a regular purchase.

- *History.* This is generally not a strong factor, although in the Pennsylvania pizza connection example it did play an important part.

Vending Machines and Movie Theaters

This category covers a broad range of activities that have in common a highly variable volume of cash receipts. Among the activities are penny arcades, cigarette and candy vending machines, jukeboxes, and movie theaters.

- *Revenues.* Movie theater and vending machine businesses provide an excellent way to disguise cash and provide a safe place for criminal transactions.
- *Expenses.* Expenses tend to be rather standard. A large vending distributor, however, might have a fair amount of flexibility with various transport, installation, and promotion expenses.
- *Business Features.* These vary greatly. In some cases, cigarette vending machines have been used as a means of distributing contraband or stolen cigarettes. Many of these locations can be useful for criminal transactions or contacts.
- *History.* Organized crime is famous for its involvement in the vending business. Historically, it has provided a cover for protection rackets and extortion of small businesses.

Wholesale Distribution

Wholesale distribution is a prominent part of the money laundering system and varies widely in its business structure. The managerial skill required is usually not as great as with high-volume retail businesses, although this depends greatly on the competitive environment and the type of product distributed. Wholesale distribution is attractive because it is well-embedded in a community's economic fabric, and does not necessarily arouse suspicion.

- *Revenues.* These are somewhat less attractive than other options, but with a diverse product line and falsified invoices a substantial amount of flexibility is possible.

- *Expenses.* This is an ideal industry 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. The larger the business, the more room to "play".
- *Business Features.* Since the days of Prohibition, distribution businesses have been widely known as ideal bases for criminal activity. Buildings, warehouses, transportation, and contact with retail establishments are all attractive factors. Many of the classic criminal activities (drugs, fencing, contraband) are themselves nothing more than distribution and can benefit from this kind of business cover.
- *History.* Certain distribution industries, such as food and liquor, historically have been associated with criminal activity. There are no rules, however, and there is large variation from one part of the country to another.

Other Businesses

Other candidates for money laundering activities are not lacking. Almost any business can be used to some degree. Remaining candidates generally fall into two groups however:

- *"Mainstream" Businesses.* This refers to activities which are common in most communities and well woven into their economic fabric. They have some limited money laundering potential, but, more important, they present the advantage of not arousing suspicion and permitting the owner to require legitimate influence in the community. There are many possible candidates in this category: automobile dealerships, automotive repair shops, appliance and appliance repair operations, taxi services, car and equipment rental outlets, motels, custodial services, caterers, medical or dental laboratories, small machine shops or specialized manufacturing operations, and health spas. The list could go on.[10]
- *"Historical" Businesses.* These are activities which, rightly or wrongly, have long been associated with criminal activity, in large part owing to organized crime infiltration. Though not always ideal from the standpoint of money laundering, they cannot be ignored as possible candidates, particularly if intelligence indicates that they are crime-infiltrated in a particular area. A few of the more obvious candidates are trash collection, junk dealers, labor unions, and the construction industry.

Enforcement Strategies

How can the knowledge of money laundering mechanisms, detection techniques and target businesses be useful to local law enforcement agencies? The potential benefits arise largely in gathering intelligence and accumulating evidence for prosecution under criminal and asset-seizure provisions of the law.

Intelligence Gathering

Information on money laundering activity should be seen foremost as an extension of the normal intelligence-gathering process. Because of the vital role of money laundering in permitting a person to enjoy the fruits of criminal activity, information on money laundering mechanisms has strong predictive value. If you know how a mechanism works, you can take advantage of it to anticipate what the person will do. Because money laundering is not directly related to criminal activity, the criminal is also less likely to exercise the same level of caution in carrying out these activities. Further, the launderer is not likely to anticipate local law enforcement capacity in this area.

What one decides to do with this predictive capacity will depend on the situation, but the possibilities are:

- improved targeting of surveillance resources;
- developing leads among suppliers and customers;
- identifying potential witnesses in the gray area between criminal and legitimate activity who, not being part of the criminal organization itself, can be the source of important information or testimony.

Evidence for Prosecution

Money laundering often involves falsification of records or legal documents, and so it may constitute a crime in its own right—depending on applicable state and federal law. As such, it can be used to prosecute cases where the basic criminal activity is hard to get at. In much the same way, major organized crime figures have been sent to prison for tax evasion. In certain states, as a result of asset seizure legislation patterned after the Federal RICO laws, civil actions can deprive the criminal organization of the fruits of its activity. In some cases, the seized assets may even be used to fund investigative activity itself, a form of "poetic justice."

Development of Information

Information on money laundering should be developed primarily by traditional investigative methods, such as informants. The range of possible informants, however, is considerably expanded because of the personnel structure of the business sector. Disgruntled former employees, clients, or suppliers of a business can provide valuable leads. Attempts to generate information by subpoena of records or other direct means before the money laundering mechanism is clearly understood may sacrifice the vital element of surprise. The criminal's need to launder money is an important asset for local law enforcement agencies. It is an asset because criminals: (a) are often not aware of their own vulnerability in the money laundering process, and (b) currently do not credit local law enforcement agencies with the capability of recognizing such activity. One way to ensure that moves are made at the right time is to develop relationships with financial professionals, from CPAs and internal auditors, to experts in the operation of particular businesses that appear to be havens for laundering.

Consultation with Experts

The best relationship to establish with a professional accountant is a continuing one that will permit you to "bounce off" ideas or help you to clarify details of money laundering mechanisms as they are revealed. Needless to say, these persons must be worthy of your trust. Consultation (preferably with a professional who has investigative experience) is absolutely essential before any decision is made to "blow cover" and subpoena the records of a suspect business.

A few basic facts need to be recognized in consulting with financial experts such as CPAs or IRS and state tax auditors:

- The usual investigative goals of CPAs and tax auditors are normally not the same as those of the law enforcement official seeking to use money laundering information for investigative purposes.[11]
- For reasons of jurisdiction and confidentiality, CPAs or tax auditors who have audited the books of a targeted company will not share the information with police authorities. Financial statements, however, can often be acquired from bankers. CPAs, unlike lawyers, do not benefit from the client privilege. Their workpapers thus may be subpoenaed.

Conclusion

Exploitation of the money laundering process as a weak point in the armor of criminal activity should be viewed as another tool in the criminal investigative process. It is a useful tool, certainly, but at the level we are discussing, it cannot substitute for other, more traditional forms of investigative effort. The strategies detailed above would rarely justify a major shift of resources within a department. They might, however, suggest a different way of approaching the investigative process, in some carefully chosen cases, and could provide the extra margin of evidence that leads to a successful prosecution—and lucrative seizure of assets.

Endnotes

1. For information on large-scale money laundering practices, see other reports in the Bureau of Justice Assistance-Police Executive Research Forum series on asset forfeiture.

2. *The Cash Connection* (President's Commission on Organized Crime: Washington, D.C., 1984).

3. The financial system (banks and other institutions) provides another way of achieving this goal, without directly involving a business. The use of financial institutions to launder money is covered in the paper by Charles Morley, *Tracing Money Flows through Financial Institutions*, available from the Police Executive Research Forum.

4. Interestingly enough, there are examples of criminals who have paid significant amounts of taxes to conceal the illicit source of their income.

5. The famous corporate "war chest" of the Watergate scandal was constituted in very much this way.

6. For the sake of clarity, it is assumed that no changes in assets or liabilities have occurred during the year, except those related to normal business activity and the accumulation of extra cash in the company's bank account.

7. See *A Report of the Study of Organized Crime's Infiltration of the Pizza & Cheese Industry*. (St. Davids: Pennsylvania Crime Commission, 1980.)

8. See C. Karchmer, *Illegal Money Laundering* (Washington: Police Executive Research Forum, 1988.)

9. Their only drawback, perhaps, is that their strong suitability for money laundering is a widely known fact. As a result, these establishments are often closely watched by law enforcement agencies.

10. It should be noted that none of these activities has any documented historical connection to criminal activity.

11. In fact CPAs and tax auditors do not even have the same goals. Simply put, CPAs perform audits for bankers and investors who want to find out if a company's revenues are really as *high* as it says. The IRS performs audits to find out if a company's revenues (and their taxes) are really as *low* as it says.

About the Author

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Police Executive Research Forum

The Police Executive Research Forum is the national professional association of chief executives of large city, county, and state police departments. The Forum's purpose is to improve the delivery of police services and the effectiveness of crime control through several means:

- the exercise of strong national leadership;
- public debate of police and criminal justice issues;
- research and policy development; and
- the provision of vital management and leadership services to police agencies.

Forum members are selected on the basis of their commitment to the Forum's purpose and principles. The principles which guide the Police Executive Research Forum are that:

- Research, experimentation, and exchange of ideas through public discussion and debate are paths for development of a professional body of knowledge about policing;
- Substantial and purposeful academic study is a prerequisite for acquiring, understanding, and adding to the body of knowledge of professional police management;
- Maintenance of the highest standards of ethics and integrity is imperative in the improvement of policing;
- The police must, within the limits of the law, be responsible and accountable to citizens as the ultimate source of police authority; and
- The principles embodied in the Constitution are the foundation of policing.

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