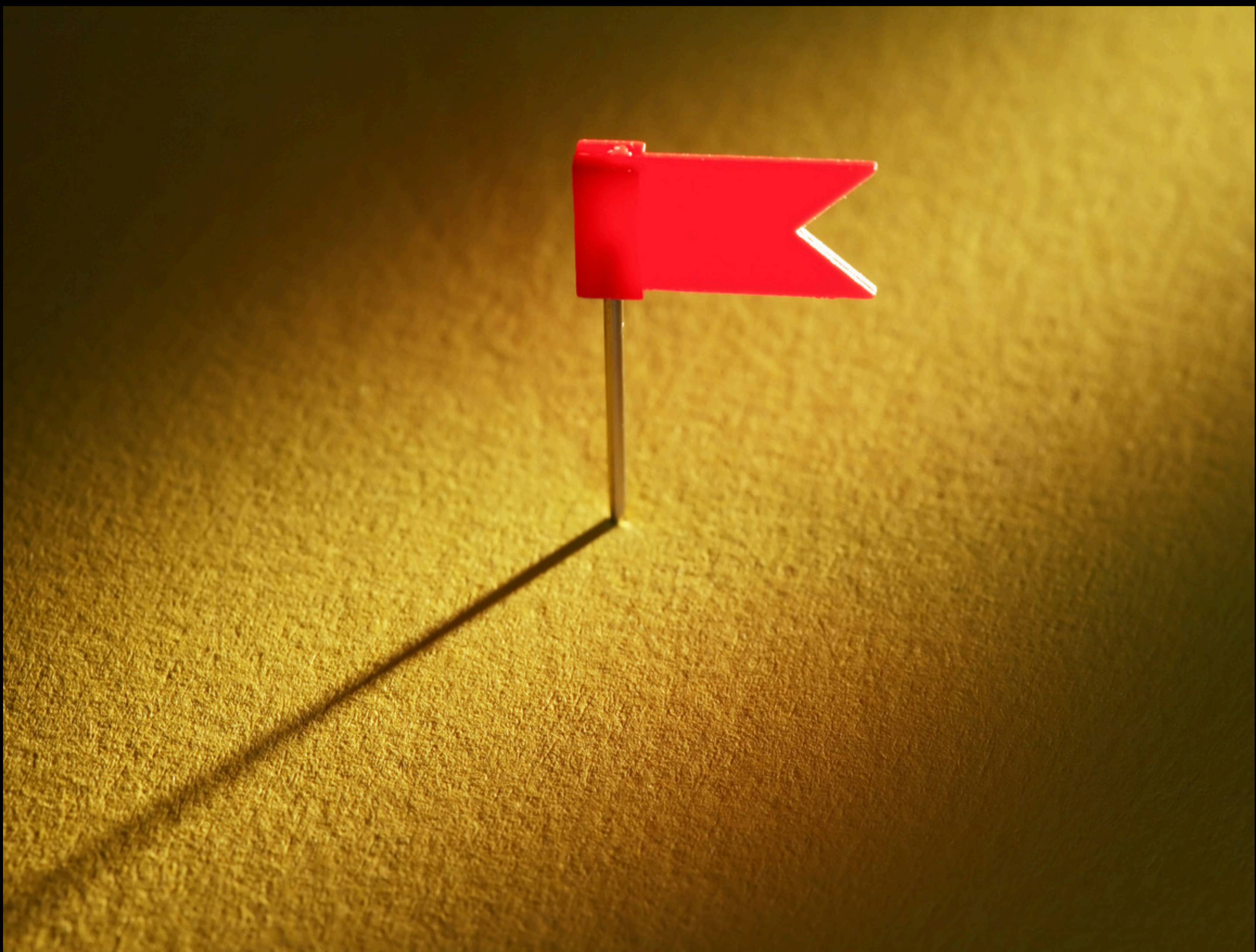
Financial Intelligence Analysis Unit
Malta

Guidance Document

SA25-01

Key Red Flags in Financial Statements and other Non-Financial Information: Insights from the FIAU



Introduction

This paper aims to guide readers in identifying key money laundering red flags frequently encountered by the FIAU in a company's financial and non-financial information. The information provided in this paper is intended for general guidance purposes only and should not be considered as binding or exhaustive.

The red flags outlined in this paper are based on the FIAU's analysis of submitted reports. This list is not exhaustive, and the presence of a single red flag does not automatically indicate illicit activity. Red flags should be assessed collectively and in context, as potential indicators of suspicious activity related to money laundering or terrorist financing, rather than conclusive evidence.

Reporting entities are encouraged to quote the code outlined in this guidance document (SA25-01) within any suspicious reports submitted through the guidance of this document.

1 Red-Flags Emanating from Financial Statements and Other Relevant Financial or Non-Financial Information

This section delves into the common red flags identified by the FIAU within financial statements and other relevant financial or non-financial information. While focusing on the main line items typically exploited for money laundering, it is crucial to acknowledge that alternative components of a company's finances can also be manipulated for illicit purposes. This section explores the intricate relationship between these elements from an anti-money laundering perspective, providing insights into how seemingly unconnected pieces of information can collectively indicate potentially suspicious activity.

1.1 Income Statement

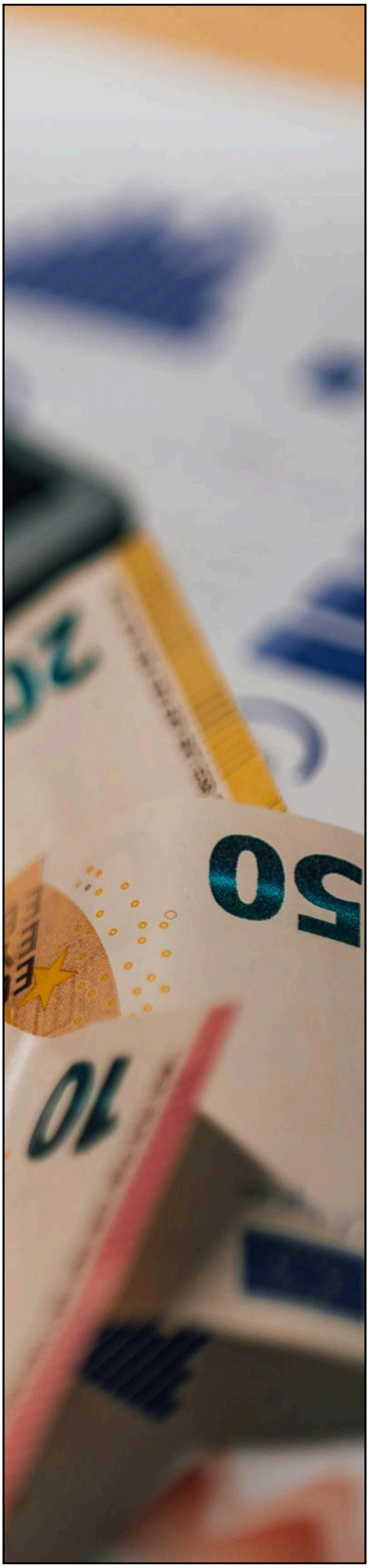
1.1.1 Revenue

Revenue is a crucial starting point for identifying potential money laundering. In this regard, subject persons should examine several key factors, including but not limited to:

Revenue Fluctuations: Sudden spikes or dips in revenue may be considered a red flag of potential money laundering. Unexpected surges, especially without increased investment or marketing, could indicate an influx of dirty money. Conversely, sharp declines might suggest a shift in laundering activities to another business. If, for example, a restaurant reports large, non-seasonal revenue spikes, then the subject person should scrutinise further.

Cash vs. Credit Sales Ratio: A much higher cash sales ratio than industry averages might suggest illicit activities, especially since cash plays a critical role in most crimes. However, subject persons should always consider the business model and compare it to its industry counterparts. In this regard, a suspicious report should be sent to the FIAU if the subject person is not convinced about the levels of cash being injected into the business. An example of this is a company that reports 90% of its sales in cash when others operating in the same sector typically only report 40% of their sales in cash.

Customer Demographics and Concentration: While customer demographics may not be readily apparent in statutory financial statements (unless specifically segmented), subject persons should strive to understand the business' customer base and identify any inconsistencies between sales patterns and customer locations. For instance, a sudden surge in sales from geographically distant or unrelated markets, particularly for a business with a traditionally local focus, could indicate potential money laundering. Comparing sales patterns with the company's marketing strategy can help determine if these sales have a legitimate basis.



1.1.2 Purchases & Inventory

When analysing inventory purchases and inventory levels, subject persons should be mindful of their potential misuse for money laundering. The following are two typical scenarios showcasing how inventory can be used as part of the money laundering process:

A business may inflate or deflate the value of its inventory to justify additional cash outflows or inflows. To detect this, whenever possible subject persons should:

- Review accounting policies related to inventory valuation for consistency and reasonableness.
- Examine the gross margin for significant fluctuations or deviations from industry norms.
- Compare the inventory values to industry norms.

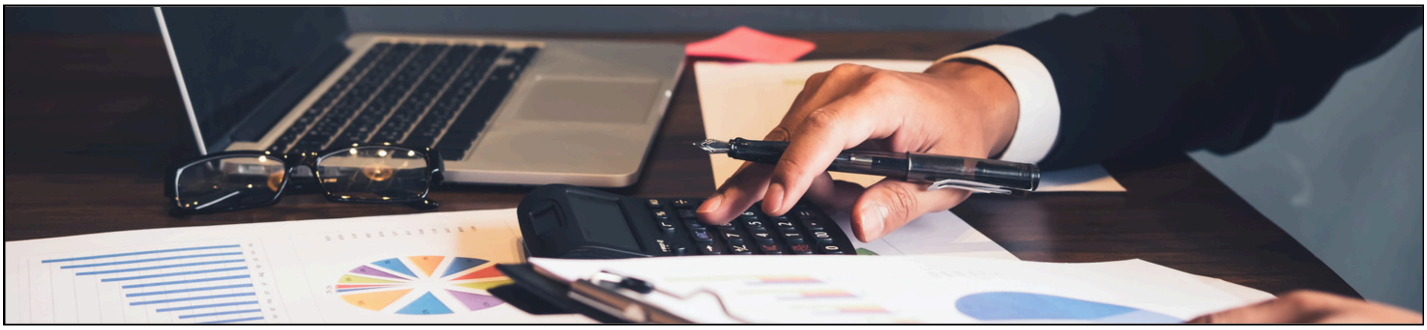
Money launderers might create false invoices for fictitious stock purchases. This would allow the business to funnel dirty money out of the business to complicit counterparts.

Whenever possible, subject persons can:

- Review accounts payable and purchases for unusual or suspicious transactions.
- Check for duplicate or inconsistent invoices, including mismatched dates, amounts, or supplier information.
- Review supplier relationships, verifying the legitimacy of suppliers and examining any unusual patterns of transactions.

- Examine inventory movement and reconciliation, looking for discrepancies between recorded inventory and actual stock.
- Look for cash flow irregularities, such as large, unexplained outflows related to inventory purchases.

While revenue and inventories are key areas to examine, criminals can manipulate other areas of their finances to conceal illicit funds. Subject persons should also consider other financial components where anomalies may arise.



1.1.3 Salaries and Wages:

Whenever necessary and possible, subject persons should examine salary and wage expenses for a range of potential red flags, The checks can include but are not limited to:

Employee Count vs. Operational Scale:

- Whenever possible, subject persons should compare the reported number of employees with the company's operational scale and industry norms. A small company with a disproportionately large workforce may be indicative of illicit activity such as human trafficking. For instance, the FIAU identified a potential human trafficking case where a business with a limited financial footprint was allegedly employing a relatively large number of individuals from a specific demographic.

Unusually High or Low Salary Expenses:

- When reviewing salaries and wages, comparing them to industry benchmarks is essential. Unusually high overall salary expenses or individual wages could point to an inflated payroll, possibly used for money laundering. Conversely, a low number of registered employees accruing a relatively low salary expense that does not align with the business's activity, such as in restaurants with large operations, can indicate tax evasion through an undeclared workforce or even labour trafficking.

Suspicious Payments:

- One-time bonus payments or payments to individuals without clear roles or responsibilities could be used to disguise the transfer of illicit funds. Payments to individuals or entities in high-risk jurisdictions or with opaque ownership structures would usually require extra scrutiny

1.1.4 Consulting Fees/Professional Services:

These line items are often used to disguise payments to complicit individuals or companies. Subject persons should look for large, unexplained consulting fees, especially to companies with vague or unrelated business descriptions. The legitimacy of the underlying consulting agreements should be analysed and the provided services should be clearly documented. Furthermore, payments to consultants in unrelated or high-risk jurisdictions should be scrutinised deeper.

1.1.5 Marketing/Advertising Expenses:

The FIAU has frequently identified marketing and advertising expenses as being used for money laundering purposes. These can be inflated or manufactured to justify cash outflows to fictitious advertising agencies or marketing firms. Subject persons should scrutinise advertising expenses for excessive spending relative to the business's size and market presence.

1.1.6 Loan Interest/Interest Expenses:

Loans from unusual sources, very high interest rates, and interest-free loans that do not make business sense are typical money laundering red flags. The subject person should therefore examine if the company is paying interest for a fictitious loan to a company within the same group of companies, or a company owned by a related party or a third party whose business relationship is not clearly defined. If so, further investigation should be carried out by the subject person to assess the legitimacy of the loan and the subsequent interest payments in question.

1.1.7 Rent/Lease Expenses:

Subject persons should scrutinise rent/lease expenses for potential money laundering risks. They should seek to verify the lessor's legitimacy, especially for vague or high-risk entities. The rates at which property, plant, equipment, or land and buildings are rented should also be compared to market values with any deviations requiring further investigation. Large upfront or cash payments and inconsistencies in payment records should also be examined further and supported by proper documentation.

1.2 Profitability Levels

Subject persons should also examine the business' profitability levels. Companies experiencing sustained losses or minimal profits over several years may warrant further scrutiny. This raises questions about the business's viability as a going concern and the potential motives behind continued operation. Comparisons against industry averages might also help subject persons perform the necessary checks. Sustained losses should prompt questions about why the company has not seized its business operations. Furthermore, a company failing to record a profit for a sustained period while expanding its business operations can also be regarded as a red flag.

1.3 Assets and Liabilities

Subject persons should also assess the risks of ML/FT emanating from a company's assets and liabilities. While some balance sheet items are particularly vulnerable to abuse, all should be considered.

1.3.1 Shareholder Loans/Advances and Related Party Balances

Amongst the most common balance sheet line items that are prone to being used for money laundering are shareholder loans/advances and related party balances. Typical red flags associated with the above include, but are not limited to:

- The provision of loans from persons or entities whose source of wealth is unknown, especially in the case of large loans.
- Loans carrying unusually high interest rates.
- Loans carrying no interest rates.
- Frequent transactions with related parties (companies or individuals controlled by the shareholder) with no apparent economic justification.

When examining these loans or transactions, it is important to consider their scope, applicable interest rates and repayment terms, as well as the jurisdictions where the accounts are located.

1.3.2 Bank Accounts

Subject persons should thoroughly examine bank accounts, especially foreign ones, by determining their purpose, analysing transactional activity for unusual patterns, verifying counterparty legitimacy, assessing geographic risk, reviewing documentation, examining related party transactions, and possibly verifying the source of funds.

1.3.3 Accounts Receivable

Subject persons should pay close attention to accounts receivable which can be manipulated to disguise illicit funds. Red flags include the existence of unusually large or aged receivables, especially from unknown or high-risk customers. Write-offs or bad debts should also be analysed as these can be used to disguise fund transfers. Subject persons should therefore seek to verify the legitimacy of customer invoices and sales transactions, in line with the points highlighted in the 'Revenue' section of this paper.

1.3.4 Accounts Payable

Accounts payable can be used to funnel money to complicit suppliers. Subject persons should examine payables to suppliers in line with the points highlighted in the 'Purchases & Inventory' section of this paper.

1.3.5 Non-Current Assets

The valuation and acquisition of non-current assets can be used for money laundering purposes. Subject persons should look for the overvaluation or undervaluation of these fixed assets, which can be used to manipulate financial statements or disguise the inflow or outflow of illegitimate funds. Purchases of assets with cash or funds from unknown sources should also be assessed carefully.

1.3.6 Intangible Assets

Subject persons should be wary of inflated values of intangible assets such as trademarks or patents. They should further examine the legitimacy of intangible asset acquisitions and, if possible, their respective valuations.

1.3.7 Cash and Cash Equivalents

Significant cash balances that appear inconsistent with the nature and scale of the business's operations, and cash transactions that raise concerns, warrant further scrutiny. Subject persons should analyse cash flows, comparing them to industry norms and historical patterns. Any unusual or unexplained cash activity should be investigated to determine if it indicates potential money laundering.

1.3.8 Investments

Investments in obscure or high-risk financial instruments, and investments in companies with opaque ownership structures, can be used to conceal illicit funds. Subject persons should carefully examine the nature and source of these investments.

1.3.9 Equity

Unusual changes in equity accounts, such as large capital injections from unknown sources or transactions involving issuing shares to complicit companies and/or individuals should be thoroughly investigated.

2 Corporate Structure and Governance Red Flags

While the income statement, statement of financial position, and cash flow statement of a company provide valuable insights into a company's financials and position, a comprehensive money laundering assessment requires examining a broader range of information. Apart from the non-financial information highlighted in the earlier sections of this paper, corporate documents and records can reveal crucial details about a company's ownership, governance, and operations. These documents can expose red flags related to the company's structure, activities, and the individuals involved. The following are some key areas and documents that can be scrutinised.

2.1.1 Memorandum & Articles of Association

In the case of companies, the Memorandum of Association outlines the company's essential and fundamental information, including its objectives, share capital details, and key individuals involved. The Articles of Association establish the rules for the company's governance and internal regulations. Subject persons should scrutinise discrepancies between the information in these documents and the company's factual operations. Typical red flags include, but are not limited to:

Activities Beyond the Company's Objects:

- While it is acknowledged that Objects and Power clauses are usually drafted in such a manner as to allow for a broader range of activities a company may carry out, activities that are unrelated to the company’s purpose/s should be questioned. By way of example, a supposed construction company buying a large quantity of mobile phones for resale raises questions about the rationale and potential trade-based money laundering implications.

Lack of Expertise and/or Relevant Experience:

- The Memorandum of Association and statutory documents identify the company's shareholders and directors. This information can be used to check even through publicly available information whether the persons concerned have any experience or expertise related to the main object/s of the company. A lack of expertise can be a red flag, but legitimate reasons should be considered (e.g., inheritance of shares). It is also understood that in some business ventures, one party provides the funding while another contributes experience and expertise. However, it would be unusual if all parties involved in the company had no prior experience in the chosen operational sector. If, for instance, a marketing company is solely owned and directed by an individual who has no prior experience or exposure in the marketing industry, then the subject person should carry out checks to ensure that the existence of the business is not simply a front to justify transfers of funds or other financial activities. Moreover, this suspicion can be strengthened if the marketing company does not have an online presence or is not marketing itself. On the other hand, one should note that small businesses, especially startups, can naturally lack an online presence early on.

2.1.2 Incorporation Date

The company's incorporation date is another factor to consider vis-à-vis the volume and value of activity undertaken. Newly formed companies carrying out an extensive level of business activity within a short period, comparable to established businesses, may warrant further scrutiny by the concerned subject person. On the other hand, one should note that a rapid buildup of activity might be legitimate if tied to known factors like investor backing or significant pre-launch efforts.

2.1.3 Shareholder/ Beneficial Owner Changes

Beyond the initial profile of shareholders and directors, subject persons should also consider any recent changes in the company's ownership or management structure. This includes looking into any shareholder changes that might have been carried out to obscure the actual beneficial ownership. Additionally, the complexity of the corporate structure should be evaluated, as overly complex arrangements can raise concerns.

2.1.4 The Audit Report

According to Accountancy Europe (2018)[1], auditors cannot directly prevent financial crime, however, their work can be tailored to increase the chance of detecting it. The full access to company information usually granted during an audit, as implied by International Standards on Auditing, together with a risk-based approach, should help the auditor identify the areas of the organisation that could pose a risk of money laundering or terrorist financing. Subject persons should therefore assess the audit report thoroughly, especially when the audit report carries a qualified opinion, disclaimer of opinion, or an adverse audit opinion. Furthermore, the resignation or removal of an auditor should also be given due regard by the subject person.

[1] https://www.accountancyeurope.eu/wp-content/uploads/2022/12/Communication-Auditors-role-in-the-fight-against-fraud-and-corruption-3.pdf

3 Conclusion

This paper has provided insights into key money laundering red flags identified by the FIAU in company financial and non-financial information. The selected red flags presented in this paper are based on the FIAU's analysis of a sample of submitted reports and are not intended to be an exhaustive list of all possible indicators a subject person might encounter or should consider when raising a suspicious report.

It is important to emphasise that the presence of any red flag discussed in this paper does not automatically indicate illicit activity. These factors should be assessed within the appropriate context and not be viewed as definitive evidence of suspicious activity related to money laundering or terrorist financing.

The information provided in this paper is intended for general guidance purposes and should not be considered binding or exhaustive. Subject persons should always refer to the relevant laws, regulations, and documents issued by the FIAU and other competent authorities when conducting their obligations at law. This paper does not replace or supersede any existing obligations or responsibilities of the subject person.

Questions on this document or on the application of AML/CFT measures may be sent to queries@fiaumalta.org

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