

**How a Regulated Accounting Industry in Latvia Would Provide
Advantages from the Perspective of AML**

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Executive Summary

The purpose of this paper is to identify facts and circumstances that explain why outsourced accountants in Latvia (who may detect criminal intent in its initial stage, before it is realised as a business transaction, and are more independent in their daily work compared with a company's accountant) are among the most important people in combating money laundering. The paper also seeks to introduce a new approach to detecting shell companies in Latvia. Additionally, it will outline the current legal framework of anti-money laundering (AML) in Latvia and recommend changes to strengthen the fight against money laundering (ML).

In 2018, the entire financial sector of Latvia experienced a significant shock due to the involvement of the third-largest bank¹ in money laundering and sanctioned relationships. This was the result of insufficient compliance and monitoring of money laundering activities. Based on a report by the United States (U.S.) Department of the Treasury Financial Crimes Enforcement Network (FinCEN), the bank's transactions were terminated as they were with a sanctioned country, North Korea, and involved laundered money. This resulted in the liquidation of the bank. Additionally, the bank supervisory body, the Financial and Capital Market Commission (FCMC), increased its supervision of other banks and required all Latvian banks to revise their AML programme.

The greatest attention in Latvia and abroad is paid to the financial sector, especially banks, leaving one of the most important control sectors unnoticed: outsourced accountants. In fulfilling the requirements prescribed by the Prevention of Money Laundering and Terrorism Financing (PAMLTF) Law, outsourced accountants may detect AML violations prior to their being committed. The daily work of outsourced accountants is related to checking document circulation. They execute payments or approve them, and only then do financial institutions get involved in the process, during the preliminary checking of the relevant payment. Outsourced accountants are the employees who may detect and better understand if the relevant transaction has an economic reason.

One of the most prominent components of ML operations is shell companies, or companies without substance. Shell companies are an effective way to conceal the true beneficiaries and the true purpose of a company. Shell companies are used for the placement and the layering stages of ML, thus increasing the size of the shadow economy. This was revealed in the bribery scandal at Rīgas Satiksme,² where a chain of shell companies was involved in receiving bribes for Rīgas Satiksme's management.

Outsourced accountants need to pay more attention to companies whose countries of registration have a higher ML risk—companies that are registered and have a bank account in a different country, a feature of shell companies used for ML. Outsourced accountants need to have in-depth knowledge of how and where to obtain information about companies registered in other countries and the AML regulations of the respective country of

¹ ABLV Bank AS is one of the largest private banks in the Baltic states, headquartered in Riga, Latvia, with representative offices abroad. ABLV has three primary lines of business: private banking, investment, and financial planning.

² Rīgas Satiksme is a municipally-owned public transportation and infrastructure company serving Riga, Latvia, and the surrounding areas. It was founded on 20 February 2003 as an umbrella organisation for the respective operators of trams, buses, and trolleybuses in the city of Riga.

registration. Such knowledge requires additional in-depth training for outsourced accountants, and it would be much more efficient to carry out and control this process if such knowledge were provided to outsourced accounting firms that offer their services to businesses at high risk for ML.

Introduction

Compliance with the law is critical for detection of suspicious transactions and money of unknown origin at financial institutions, as any negligence or violation committed is perceived by society in an exacerbated manner. In certain situations, where information has become publicly available on lack of action or inadequate decisions regarding the existence of illegal money or transactions in Latvia, society has already formed a negative attitude towards the operations of the government and state administration in general, but not towards banks and ML as a problem in Latvia. This needs to change.

During the period of 2013 to 2018, for violation of anti-money laundering and terrorism financing requirements, the Latvian State Revenue Service (SRS) applied one sanction per year, except for 2015 and 2016, while the proportion of the shadow economy did not change significantly during the entire period. In 2017, the shadow economy in Latvia increased by 1.3% and formed 22% of GDP,³ which is closely related to ML risks. The components of the shadow economy in Latvia are as follows: failure to indicate income (profit) and the number of employees, envelope wages, bribes, and interest from the contractual amount paid to secure government orders. Envelope wages have the greatest proportion (45.5%). According to the study *Shadow Economy Index for the Baltic Countries 2009–2017* by Dr. Tālis J. Putniņš and Dr. Arnis Sauka, companies hide approximately 20% of the salary actually paid from the state. At the same time, 8% of income is paid as a bribe, while last year companies paid 10% of the contractual amount to get a government order. The average proportion of income not indicated by companies last year was 17%.⁴

Any violations in the AML area significantly reduce the confidence rating of Latvia among European Union member states and the United States. This influences investors' decisions on investments in Latvia and local businesses.

Outsourced accountants, subjects described in Section 3, Paragraph 1 of the Law on the Prevention of Money Laundering and Terrorism Financing (PAMLTF),⁵ are most closely connected to matters related to the AML legal framework, including working with companies' fundamental documents, processing and evaluating transactions, and, if necessary, declining a transaction.⁶ In addition to these processes, outsourced accountants carry out an evaluation

³ Publication in the newspaper *Dienas Bizness* from 16 May 2018. This publication deals with the shadow economy in Latvia, pointing out that it increased in 2017 compared with 2016. The publication discloses the business realms with the highest participation in the shadow economy in Latvia.

⁴ SRS publication provides information on the results of the Latvian State Revenue Service's tax control measures in the first half of 2018. Among other things, it summarises the results of the tax controls, the additional tax amounts calculated and penalties applied, the preventive effect of SRS tax controls, and the results of the SRS's work with taxpayers regarding doing business with risky business partners.

⁵ Law on the Prevention of Money Laundering and Terrorist Financing, Section 3, Paragraph 1, Riga, 30 July 2008. The regulation states the subjects of this Law.

⁶ Law on the Prevention of Money Laundering and Terrorist Financing, Section 32, Riga, 30 July 2008. The regulation states that a subject of this Law shall take a decision regarding refraining from executing one transaction or several mutually linked transactions or from a definite type of debit operations in the customer's account, if the transaction is related or there are substantiated suspicions that it is related to money laundering or terrorism financing.

of the transaction partners by verifying available information on them in various databases; identifying registration data, financial information, and any liabilities against the State Revenue Service (SRS); and inspecting the sanction database. In order to identify a suspicious transaction, an outsourced accountant must have adequate knowledge regarding the handling of accounting data, as established by the Law on Accounting,⁷ as well as the nature and processes of AML procedures, governed by the PAMLTf Law, Cabinet Regulation No. 674⁸ and compliance with the requirements set forth therein.

Regulated Sectors

The IMF defines the shadow economy as including all economic activities which are hidden from official authorities for monetary, regulatory, and institutional reasons. Monetary reasons include avoiding paying taxes and all Social Security contributions; regulatory reasons include avoiding governmental bureaucracy or the burden of the regulatory framework; and institutional reasons include corruption law, the quality of political institutions, and weak rule of law.⁹ The shadow economy is closely linked to ML, as the shadow economy cannot exist without cash transactions, which cannot exist without ML. In order for the private and government AML models to successfully coexist, both cooperation parties need to have the same understanding of AML processes. Statistical data collected by the SRS shows that neither the government sector (the SRS as a supervising and controlling institution), nor the private sector (accounting companies) have sufficient understanding of the AML process.

As shown by the SRS tax control measure results for the first half of 2018, during the cash transaction declaration check at 30 companies, 23 of them were found to have violations, while during the accounting documentation check at 718 companies, violations were detected in 631 cases. In 100 thematic checks of used car dealers, 98 violations were revealed.¹⁰

As noted by the SRS in its report: “Actions taken by the SRS were more directed towards the liquidation of damages”, which explains the poor results of the aforementioned SRS operational checks.

Licensing and certification of accounting service providers in the AML area would significantly improve fulfilment of the requirements set in the PAMLTf Law, Cabinet Regulation No. 674, and the Accounting Law.

It is necessary to define construction, car trading, and wood industries as realms with a high ML risk, along with the operational areas of the subjects of Section 3 of the PAMLTf Law.

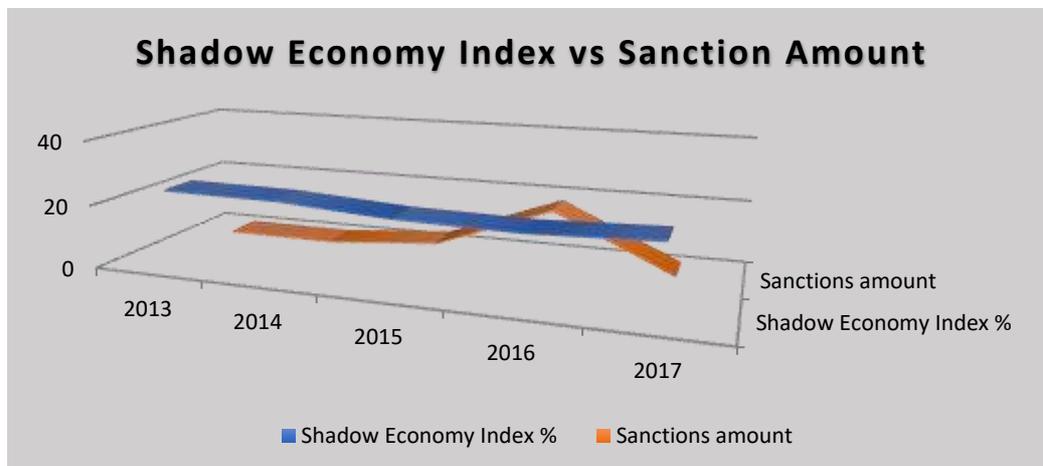
⁷ Law on Accounting, Riga, 14 October 1992. The regulation states who the subjects of the Law are, general provisions on how accounting shall be conducted, and that the accounting information provided shall be truthful, comparable, timely, significant, understandable, and complete, the outsourced accountant’s obligation being to insure his civil liability.

⁸ Regulations Regarding the List of Unusual Transaction Indications and the Procedures for Submitting Reports on Unusual or Suspicious Transactions, Riga, 14 November 2017. The regulation prescribes the list of unusual transaction indications and the procedures for submitting reports on unusual or suspicious transactions and approves the report form.

⁹ *IMF Working Paper: Shadow Economies Around the World: What Did We Learn Over the Last 20 Years?*, January 2018. The *IMF Working Paper* is an extended discussion of the latest developments in estimation methods for the shadow economy. It includes new results on the shadow economy for 158 countries all over the world. The strengths and weaknesses of these methods are assessed, and a critical comparison and evaluation of the methods is carried out. The average size of the shadow economy of the 158 countries is estimated.

¹⁰ SRS publication available at https://www.vid.gov.lv/sites/default/files/2018.gada_1.pusg_.pdf. The survey comprises the SRS’s information on the results of the Tax Control Department’s tax control measures in the first half of 2018. It includes a summary of the results of the tax controls, the results of tax audits, and the results of thematic checks that revealed the violations.

Companies operating in sectors with a high ML risk must mandatorily attract licensed accounting companies for the daily processing of accounting data, regardless of whether or not the company must prepare an annual report with a sworn auditor's report.



Graphic image created by the author, using the SRS Statistical Data for the Sanctions Applied for Violations of the Requirements Prescribed in the Law on the Prevention of Money Laundering and Terrorism Financing and the Shadow Economy Index for the Baltic Countries 2009–2017

The proportion of companies operating in the area of construction and road construction in the shadow economy in Latvia is 35.2%, the largest proportion in the shadow economy, while the wood industry is part of the manufacturing sector, the proportion of which in the shadow economy is 20.3%.¹¹

Accounting companies should ensure appropriate compliance with AML standards. Thus, both the SRS and accounting companies' supervising institution should carry out more stringent control over these high-risk companies through strong regulation of accounting companies, including control over the implementation of training processes in combating money laundering and terrorism financing at these companies.

Regulation Overview

Who Must Comply

Matters of money laundering and terrorism-financing risks in Latvia are governed by the PAMLTF Law, the Law on International Sanctions and National Sanctions of the Republic of Latvia (Sanctions Law).¹² The PAMLTF Law establishes who the subjects and target audience of the Law are, including credit institutions, financial institutions, tax consultants, outsourced accountants, sworn auditors, and commercial companies of sworn auditors (in total 11 subjects) affected by money laundering and terrorism-financing risks. The requirements of

¹¹ *Shadow Economy Index for the Baltic Countries 2009-2017*. The SSE Riga *Shadow Economy Index* is estimated annually based on surveys of entrepreneurs in the Baltic countries using a number of surveying and data collection techniques shown to be effective in eliciting relatively truthful responses. The Index combines estimates of misreported business income, unregistered or hidden employees, and unreported "envelope" wages to obtain estimates of the shadow economies as a proportion of GDP. This study focuses on the shadow economy estimates for the year 2017 as well as trends during the years 2009-2017.

¹² Law on International Sanctions and National Sanctions of the Republic of Latvia, Riga, 15 February 2016. The Law ensures peace, security, and rule of law in accordance with the international obligations and national interests of Latvia, introducing international sanctions or imposing national sanctions. It also states requirements regarding financial restrictions applicable for outsourced accountants.

the PAMLTF Law are applicable and binding to all subjects of the Law to the same extent, except if it is specially indicated that some particular requirement is applicable to a specific subject. For example, a prohibition on holding anonymous accounts only pertains to credit institutions and financial institutions.

Requirements

The PAMLTF Law requires subjects of the law and its requirements to comply by having an internal control system for each client that includes the identification of a natural and legal person. Also, procedures must be in place for the review of the client, and, if necessary, carrying out due diligence of the client. Procedures must also be in place to identify signs of unusual and suspicious transactions.

Legal persons shall appoint one or several employees as persons responsible for the fulfilment of the requirements of the PAMLTF Law. Such employees are entitled to adopt decisions, are directly responsible for compliance with the requirements of the Law, and ensure the exchange of information with the supervision and control authority. The company shall inform the relevant supervision and control authority regarding any changes to the composition of the relevant employees. In addition, the legal person shall appoint a board member who supervises the AML area at the respective company.

The company ensures that the responsible employees are aware of the risks related to AML, and the laws and regulations governing the area. The company shall ensure regular training of the AML-responsible employees to improve their skills in detecting signs of unusual or suspicious transactions and take any actions prescribed in the control system. The company must also train the rest of the employees in AML matters.

The supervision and controlling authorities prescribed in Section 45 of the PAMLTF Law shall ensure that subjects of the PAMLTF Law comply with the obligation imposed in the Sanction Law to document the fulfilment of the risk assessments of international and national sanctions in accordance with their type of operation. Risk assessment is necessary in order for subjects to establish, assess, understand, and manage the sanction risks pertaining to their operations or clients.

Shell Companies

Overview

The definition of a shell company is rather broad. For example, the Financial Action Task Force (FATF), an independent intergovernmental organisation developing and facilitating the political guidelines for the protection of the global financial system against money laundering, terrorism financing, and financing of distribution of weapons of mass destruction, considers shell companies to be companies that are incorporated and have no significant operations or related assets.¹³

¹³ *FATF Guidance: Transparency and beneficial ownership*, October 2014. The Guidance defines beneficial owners, persons who exercise ultimate effective control over the legal arrangement. It provides measures to prevent the misuse of legal persons for money laundering or

The Wolfsberg Group, a nongovernmental association, formed by 13 international banks, which develops standards for the prevention of money laundering and terrorism financing for financial institutions, states that a shell company is a company that either has no operations, or has assets consisting solely of cash and cash equivalents, and nominal other assets. It also states that a shell company has no active business and usually exists only in name as a vehicle for another company's business operations.¹⁴

FinCEN defines a shell company as a company which does not have active business activity and usually only exists as a tool for the business activity of another company, indicating that the term "shell company" refers to non-publicly traded corporations, limited liability companies (LLCs), and trusts that typically have no physical presence (other than a mailing address) and generate little to no independent economic value.¹⁵

In Latvia, the definition of shell company is prescribed in Section 1, Paragraph 15.1 of the PAMLTF Law, establishing that a shell company is a legal person characterised by one or several of the following indications:

- a) has no legal person connection with actual economic operations, and operations of the legal person create little or no economic value, and the subject of the law does not have any documented information to the contrary;
- b) in the country where the legal person is registered, laws and regulations do not prescribe an obligation to prepare and submit financial reports to the supervisory institutions of the relevant country, including annual reports for their operations;
- c) in the country where the legal person is registered, the legal person does not have a place (premises) for conducting business activity.¹⁶

Regulatory Requirements

Section 1, Clause 15 of the PAMLTF Law establishes that a shell bank is "a credit institution or a financial institution, or another institution which performs activities equivalent to those of a credit institution or a financial institution, and which has no physical presence (including the presence of its actual management) in the country in which it is registered, and which is unaffiliated with any regulated and supervised group. Also the person who provides services equivalent to those of a credit institution by carrying out noncash transfers on behalf of a third party, and whose operation is not controlled by a supervisory and control authority, except in cases when such transfers are performed by an electronic money institution, or they are performed between commercial companies of one group which are such within the meaning of the Financial Conglomerate Law, or between commercial companies which have one and the same beneficial owner, shall be considered a shell bank".¹⁷

terrorist financing and to ensure sufficient transparency of legal persons. The Guidance sets the requirements for adequate, accurate and timely information.

¹⁴ The Wolfsberg *Correspondent Banking Due Diligence Questionnaire (CBDDQ): Glossary*, 22 February 2018. The CBDDQ was released to the banking community to provide additional context and clarification, based on feedback received from the industry. The *Glossary* is a living document and is updated as new terminologies are identified.

¹⁵ US Department of the Treasury, *Financial Crime Enforcement Network: Guidance FIN-2006-G014, Subject: Potential Money Laundering Risks Related to Shell Companies*, 09 November 2006. The Guidance is issued to alert financial institutions to some of the potential money laundering risks associated with providing financial services to shell companies.

¹⁶ Law on the Prevention of Money Laundering and Terrorist Financing, *Section 1, Clause 15.1*, Riga, 30 July 2008. These regulations establish characteristics of a shell company.

¹⁷ Law on the Prevention of Money Laundering and Terrorist Financing, *Chapter I, Section 1, Clause 15.1*, Riga, 30 July 2008. These regulations establish characteristics of a shell bank.

Section 21 of the PAMLTF Law establishes a prohibition on cooperating with shell banks and shell companies. It establishes this prohibition only for credit institutions, payment institutions, electronic money institutions, investment brokerage companies, and—in respect of the management of clients' individual portfolios and distribution of open investment fund certificates—investment management companies.¹⁸ A prohibition in the PAMLTF Law must only be applied if the company conforms to both signs prescribed in Section 1, Clause 15.1, Sub-clauses a) and b) of the PAMLTF Law. Thus, the prohibition of the PAMLTF Law is not applicable to legal persons registered in Latvia. The legal framework of Latvia provides for an obligation to prepare and submit financial statements, including annual reports regarding operations, to the relevant state authorities. Thus, a legal person registered in Latvia does not conform to the description prescribed in Section 1, Clause 15.1, Sub-clause b) of the PAMLTF Law.

Money Laundering Risk

Another feature that may indicate that a potential business partner is a shell company is a dormant account, which does not meet the abovementioned characteristics of shell companies. The practice of submitting dormant accounts is in use in places such as Cyprus, Hong Kong, and Singapore. These locations have audited report submission requirements. Even more, all accounts in Cyprus and Hong Kong must be audited. None of these locations has any restrictions on how long a company can have a dormant status, so no additional monitoring of companies is carried out from the respective location's register of companies and tax office, although, at the same time, companies often do business outside their country of registration, relying on the fact that information about this will not become available to the tax office of the country of registration. Outsourced accountants should therefore ascertain whether public information on annual accounts is available or request such information from potential business partners, so that the company can comply with the terms of the cooperation agreement and so that the invoices displayed are adequate.

In Latvia, the situation with inactive companies is slightly different from the one in Cyprus, Hong Kong, and Singapore, as Section 166 of the Administrative Violation Code imposes insignificant monetary penalties for failure to comply with the Rules for Accounting, Submission of Reports, and Statistical Information with respect to natural persons or a board member; while the provision of false information, by submitting incorrect data for annual reports, is subject to a criminal penalty, and the penalty for such violations is much more stringent and includes imprisonment. Thus, the practice of not submitting annual reports is more widespread in Latvia. This is proven by the shadow economy index for 2009–2017, which shows that unreported income is 37.2% of the total proportion of the shadow economy.¹⁹

¹⁸ Law on the Prevention of Money Laundering and Terrorist Financing, Chapter III, Section 21. Riga, 30 July 2008. These regulations establish prohibition on executing transactions of any kind with shell banks, and prohibition on establishing and maintaining business relationships or executing an occasional transaction with a shell arrangement if it concurrently conforms to the indications specified in Section 1, Clause 15.1, Sub-clauses a) and b) of this Law.

¹⁹ *Shadow Economy Index for the Baltic Countries 2009-2017*, https://www.vid.gov.lv/sites/default/files/a.saukas_prezentacija.pdf (English: https://www.sseriga.edu/sites/default/files/2018-07/sseriga_shadow_economy_index_2009-2017.pdf).

Outsourced accountants must pay more attention to foreign business partners whose bank accounts have not been opened in the company's country of registration, and should request additional information regarding these companies. A bank account in the country of registration indicates that the company is a taxpayer in that country. The territorial tax system stipulates that when the profit earned outside the country of registration is transferred to the bank account in the registered country, this income is subject to income tax in the relevant country. Another risk factor regarding these companies is payment platforms, which are in demand due to their more liberal attitude toward clients and the possibility to open bank accounts for non-resident companies, allowing clients to hide the real structure of their companies. The aforementioned examples must be taken into account when developing new laws and regulations for companies and their supervising and controlling authority.

This means that the quality of the information recorded in accounting must be improved, providing precise data in a timely manner, which would facilitate work for both companies and SRS employees, save resources, and reduce the number of disputes between the SRS and companies. This would be possible if a system was introduced which allowed SRS employees to view a company's report at any time, provide consultations to companies regarding the elimination of potential errors, increase control over the companies, and find out if the relevant company is carrying out accounting. In order to do this, it would be necessary for the SRS to prepare a list of licensed accounting software which would be connected to the SRS internal system for the successful synchronisation of data. This would require training for SRS employees to work with the accounting software; thus, its number must be limited, and the software must be based on a single approach. In addition, in order to be able to carry out such consultations and control, a new legal framework would be necessary, prescribing that companies need to prepare full reports for each month.

The Role of Outsourced Accountants

Section 32, Paragraph 1, Clause 3 of the PAMLTF Law requires outsourced accountants to withhold from executing a transaction if it is related, or there are justified suspicions that it is related to money laundering or terrorism financing, or there are justified suspicions that the means are directly or indirectly obtained as a result of a crime or related to terrorism financing or an attempt thereat. Additionally, Section 32, Paragraph 3 of the PAMLTF Law prescribes that a subject of the Law, in withholding from entering into a transaction, should not take any actions with the means involved in the transaction until he/she receives an instruction from the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity (Control Service) to stop withholding from entering into the transaction.

Part 1 of Cabinet Regulation No. 674 on a List of Signs of an Unusual Transaction and Procedure for the Provision of Reports on Unusual and Suspicious Transactions prescribes that subjects of the PAMLTF Law must immediately report on each consulted, planned, proposed, commenced, deferred, executed, or approved unusual transaction, the indications of which conform to at least one of the indications referred to in the Regulation.²⁰

²⁰ Regulations on a List of Signs of an Unusual Transaction and Procedure for the Provision of Reports on Unusual and Suspicious Transactions, Part 1, Clause 2, Riga, 14 November 2017. The regulation formulates indications of an unusual transaction and how subjects of the Law on the Prevention of Money Laundering and Terrorist Financing shall fill out report forms and submit them to the control service.

It may be derived from the information prescribed in Section 32 of the PAMLTF Law that withholding from carrying out a transaction is directly related to the transfer of the funds or any activity therewith. Thus, subjects of the Law must withhold from any actions directly related to the recording of such transactions.

It may be derived from the information prescribed in Section 32, Paragraph 2 of the PAMLTF Law and Cabinet Regulation No. 674 that a subject of the PAMLTF Law not only has an obligation to withhold from conducting a transaction, but also has an obligation to provide information regarding a transaction that conforms to the signs of an unusual transaction or may be recognised as a suspicious transaction. Termination of cooperation is not a reason not to fulfil the obligation prescribed in Cabinet Regulation No. 674 to immediately report on each unusual or suspicious transaction. Thus, banks process documents verified and prepared by outsourced accountants prior to this, assessing the requirements of the PAMLTF Law and Cabinet Regulation No. 674.

Analysis of the Role of Outsourced Accountants

Supervising authorities therefore need to make changes to the relevant regulations to increase the requirements for the providers of accounting services, establishing mandatory requirements for more in-depth training and testing of knowledge of AML.

Based on the Moneyval report of August 23, 2018, the struggle to prevent money laundering and terrorism financing has increased, and the Measure Plan for the Prevention of Money Laundering and Terrorism Financing for the time period until December 31, 2019, developed in 2018, serves as proof for it. The following has been specified in the action plan: The Second National Money Laundering and Terrorist Financing Risk Assessment (NRA) states that the major threats in the AML area are crimes with the participation of PAMLTF Law subjects of the AML nonfinancial sector, including companies working in the accounting sector.²¹

In the report of this year, Moneyval noted that providers of accounting services are not sufficiently regulated and supervised in the AML area as carried out by the SRS, the supervisory institution of accounting companies. The accounting area, which is one of the most important areas in combating the shadow economy and AML risks, is weakly regulated, and any person who has gained basic knowledge in the handling of accounting data for local companies may operate therein. Such persons may be employed at one company, serve companies by providing them with outsourced accounting services, and form companies servicing other companies by providing outsourced services in the accounting area.

In cooperation with the accounting service provider association, the SRS has prepared proposals in respect of the companies working in the accounting service area, their regulation and licensing, which will definitely facilitate a reduction of the risks related to AML. Such an approach still might not bring the desired results. It is necessary to make amendments to the PAMLTF Law by establishing—for the subjects of Section 32, Paragraph 1 of the PAMLTF

²¹ *Supplemented Latvian National Money Laundering/Terrorism Financing Risk Assessment Report, The Second National ML/TF Risk Assessment 2018*, Riga, 22 June 2018. The assessment is based on overall research in Latvia and covers all business realms, assessing ML risks in each of them. It includes the SRS opinion that entry requirements set for outsourced accountants and tax consultants are insufficient, that it is necessary to develop licensing requirements, and that external accountants ineffectively submit suspicious transactions reports and, even more, have facilitated ML through the establishment of complex corporate structures.

Law—mandatory use of outsourced accountants for the preparation of monthly reports. It is also necessary to establish for accounting companies the development, introduction, and monitoring of increased AML requirements.

The measure implementation plan for 2017–2019 adopted in 2017 shows that the requirements of the PAMLTF Law and Cabinet Regulation No. 674 are not complied with in full. The only achievement in the review of the implementation course of this plan is as follows: “Providers of accounting services in 17 events have had a penalty in the amount of EUR 6.2 thousand imposed”.²² These indicators do not conform to the achievements which should exist, taking into account the volume of the shadow economy of Latvia in the amount of 22% of the gross domestic product (GDP). As described above, providers of accounting services have a great role in AML events. Insufficient AML risk assessment in respect of accounting service providers is also shown by the PAMLTF national risk assessment report, establishing that the outsourced accounting service sector has a medium-high ML vulnerability level: “The tax consultation, outsourced accounting and legal service area has a medium-high ML vulnerability risk level. A significant risk in the operations of tax consultants, outsourced accountants, and legal service providers is created by the possibility to provide services to anonymous clients and remotely”.²³

The outsourced accounting service sector itself has medium-high ML risks, but its role in identification and reporting on AML violations is not sufficiently rated, and there is a need to revise it, as outsourced accounting companies could detect and stop transactions, and report on violations more quickly. Latvia should move towards licensed and AML-certified outsourced accountants, establishing risk sectors where outsourced accounting services are mandatory. This would, at the same time, reduce the likelihood of direct influence on employees from the board of the company, their direct employer, posing the risk of employees being fired if their direct accounting obligations are not being fulfilled. It is necessary to facilitate outsourced accountants’ understanding of AML and its importance. At the same time, a functional assessment must be carried out of the SRS as the authority supervising and controlling the subjects prescribed in Section 32, Paragraph 1 of the PAMLTF Law, in order to improve the understanding of AML’s importance.

The SRS prepared a report on penalties applied for PAMLTF Law subjects during the period of November 2017 to November 2018, and only in two cases of the 15 penalties applied was a penalty imposed for failing to report to the SRS on suspicious transactions. These penalties were for suspicious transactions detected by the SRS. In another 13 cases, the penalties were related to any of the following procedural violations which were not connected to a real operation of a company in respect of the assessment of clients and transactions: A person responsible for the fulfilment of PAMLTF requirements has not been appointed; a board member supervising the PAMLTF area has not been appointed; and the SRS requirement to ensure the performance of the inspection and to present the requested documents has not

²² Information on the implementation course of the measures included in the *Measure Plan for the Restriction of Money Laundering and Terrorism Financing Risks for 2017-2019* (information for the time period up to 6 September 2017). The informative material consists of a timetable that includes descriptions of the action plans for different controlling institutions, which normative acts and regulations should be changed, and results already achieved on the date of the document’s preparation.

²³ *Supplemented Latvian National Money Laundering/Terrorism Financing Risk Assessment Report, Second National ML/TF Risk Assessment 2018*, Riga, 22 June 2018. The assessment refers to the *EC Supranational ML/TF Risk Assessment Report* (http://ec.europa.eu/newsroom/just/item-detail.cfm?item_id=81272), stating that the ML risk level among tax advisers, external accountants, and providers of legal services is high. In the *National Assessment Report*, the vulnerability of external accountants to ML has been evaluated as medium high.

been fulfilled. The proportion of these penalties shows that the SRS does not have a sufficient understanding of AML matters to be able to detect them in daily work.

This, on other hand, shows the need for an assessment of the SRS's AML work. The State Audit Office carries out an assessment of the SRS's work. Thus, the State Audit Office should establish that it must invite an expert recognised in the European Union who, together with the State Audit Office, checks SRS operations in respect of the AML supervision and monitoring system for subjects of the PAMLTf Law, as indicated in Section 32, Paragraph 1, and jointly prepares a report on the operation of the SRS AML system.

Shell companies have low costs and simplified business structures, and can also be bought as ready-made or shelf companies with different registration years, including more than one-year-old companies. In the Latvian banking sector in the first quarter of 2017, the turnover of shell companies in terms of the credit turnover of all customers was 27.8%, while in banks specializing in providing such services, it reached 44.52%.²⁴ On July 7, 2018, however, the deposits of shell companies in terms of the total share of deposits was 0.03%.²⁵ The Latvian financial sector is no longer directly threatened, but in other countries the accounts of such companies are still maintained, and, therefore, an ML risk regarding the use of shell companies remains. Outsourced accountants need to pay more attention to companies whose countries of registration have a higher ML risk and companies for which the country of registration and the bank account location differ, which are features of shell companies used for ML. Outsourced accountants need to have in-depth knowledge of how and where to obtain information about companies registered in other countries and the AML regulations of the respective country of registration. Such knowledge requires additional, in-depth training for outsourced accountants, and it would be much more efficient to carry out and control this process if such knowledge were provided to outsourced accounting firms that offer their services to businesses at high risk for ML.

Training Programme for Outsourced Accountants

In its work with accounting companies, the SRS would have to comply with the following AML training approaches in order to conform to current international practice:

Awareness – Based on the aforementioned facts in respect of the violations established during the SRS inspections, i.e. that 77% of violations were established in the declaration of cash, 88% of violations were established in accounting, and 98% of violations were established for dealers of used vehicles.²⁶

These results point to the fact that companies have insufficient knowledge and understanding of how important it is to comply with AML requirements. It is necessary to explain that the

²⁴ *Diena* newspaper, 26 April 2018, <https://www.diena.lv/raksts/latvija/zinas/aizliedz-bankam-apkalpot-caulas-kompanijas-14196188>. This publication, one of the biggest newspapers in Latvia, considers the new regulation that prohibits Latvian banks from doing business with shell companies.

²⁵ "FCMC: The Latvian banking sector is relieved of unwanted shell companies", 01 August 2018, <http://www.fctk.lv/iv/mediju-telpa/pazinojumi-masu-informacijas-l/2018/7156-fctk-latvijas-banku-sektors-ir-atbrivojies-no-nevelamiem-caulas-veidojumiem-2.html?highlight=WyjYXVsYXMixQ=->. The FCMC's publication considers the achievement of relieving the Latvian banking sector of shell companies. This result was achieved 60 days after new regulations came into force on May 9, 2018; the deadline was July 7, 2018.

²⁶ SRS publication at https://www.vid.gov.lv/sites/default/files/2018.gada_1.pusg_.pdf. The data have been modified as a percentage to be more indicative regarding the negative outcome of SRS tax controls.

sanctions prescribed in Section 78 of the PAMLTF Law may take place in the event of not fulfilling AML requirements, imposing such important restrictions as suspending or terminating operations, including suspending or cancelling licences. Also, a reputation put at risk in such a manner may cause significant financial damage.

Education – The SRS should ensure adequate, high-level training for accounting companies and prepare SRS employees so that they are able to carry out controls and provide support to companies with their knowledge in any given situation. If necessary, the SRS may attract appropriate external specialists with international experience. Before engaging external specialists, it would be necessary to assess their knowledge and experience.

Training – It is necessary to organise advanced training, to review and analyse real cases, and to organise one-day training courses during which current AML topics can be reviewed. The training may be organised by the SRS as a supervising institution or by an assessed outsourced training company. A training point system must be established for each of the AML-responsible persons that obliges AML specialists to collect a certain amount of points per annum by attending various events with a point grading system, depending on the broadness of the subjects to be discussed during the event. Such events may be attended in or outside of Latvia, which will also be considered in the calculation of the points.

Indoctrination – The SRS, in cooperation with other supervising institutions, may create an environment where AML matters are considered to be those of the greatest importance, which must be complied with. A “WE#AML™”²⁷ movement must be formed, thus showing others that participating companies, just like “ECO” companies, follow best AML practise to help create a healthy AML environment. By changing the viewpoint of those employed at accounting sector companies, we will be able to change the general attitude toward AML matters in a broader spectrum, addressing a wider range of people.

In order to more successfully implement the new AML requirements in daily work and the creation of a healthy AML environment, the SRS must analyse the following CATEGORIES:

Stakeholders – Prior to starting any preparation work, it is necessary to understand all stakeholders in this process, including the country whose reputation is damaged, companies of various sectors and their associations, the SRS as a supervisor of PAMLTF Law subjects, the FCMC as the supervisor of credit institution Law subjects, the Office for the Prevention of Laundering of Proceeds Derived from Criminal Activity (Control Service – FIU), the Prosecutor’s Office, and the Criminal Police.

Responsibilities – Taking into account the voluminous work and short deadlines established by MoneyVal, the SRS must find opportunities to establish and allocate responsibility by attracting support from societies and associations of PAMLTF Law subjects, for which it is responsible in respect of cooperation between the private sphere (subjects of the law), the government (SRS), and other supervising authorities.

Role – By dividing responsibility, it is also possible to establish the role of each individual employee, department, or cooperation partner in various stages of the process.

²⁷ WE#AML™ is a registered trademark.

Exposure – The SRS must define the minimum requirements for outsourced accountants who will have a licence to work with clients from high-risk groups and for those who will not serve clients from high-risk groups.

Likelihood – Analyze likelihood based on the SRS’s regular checks, stipulating the frequency of training, depending on the information received from the tax office in other countries or the SRS’s risk assessment. Corrective training measures must be established in the event of new information, methodologies, and sanctions.

Ownership – The main institution (department) within the SRS should define who will be responsible for the training programmes and supervision of the training and licensing process.

Creation of a Regulated Outsourced Accounting Sector in Latvia

Controlling and supervisory institutions on different state control levels should take the following steps to improve the outsourced accounting sector and facilitate AML measures:

1. The SRS must develop an action plan for regulating and supervising the licensing and certification of accounting companies in each of the following stages and risks related thereto:
 - a) Preparation measures and any risks related thereto including:
 - i. implementation methodology and criteria,
 - ii. SRS capacity,
 - iii. influence on the accounting company sector and business in general,
 - iv. supervision,
 - v. funding,
 - vi. responsible executive power, and
 - vii. non-overlapping of functions.
 - b) Implementation measures and any risks related thereto including:
 - viii. accounting company clients’ risks:
 1. change of client attitude,
 2. desire to integrate into the changes taking place, and
 3. sensitivity of clients to changes.
 - ix. mutual cooperation/non-cooperation risks of accounting companies,
 - x. an opportunity to absorb the new requirements,
 - xi. an opportunity to fulfil the new requirements, and
 - xii. a need for training,
 - xiii. communication plan,
 - xiv. getting to know all stakeholders,
 - xv. external risks,
 - xvi. external political influence,
 - xvii. legislators’ influence, and
 - xviii. other external factors that may appear during the process.
 - c) Post-implementation stage including:
 - xix. process management,
 - xx. process supervision, and
 - xxi. analysis of implementation results.

2. The government, in cooperation with experienced specialists with an adequate AML/CTF qualification, must organise discussions and events where there is an exchange of opinions. Specialists have to be fully involved in the discussions on the licensing of accounting companies and certification of AML/CTF qualifications.
3. Implement regulations for all companies operating in sectors in a risk category (risk categories are established based on the AML/CTF risk approach criteria), regardless of whether these companies conform to the conditions prescribed in Section 54 of the Accounts Law of Latvia after filing audited annual reports.
4. Define the SRS as the authority supervising and performing the licensing of these accounting companies and AML/CTF qualification certification.
5. Create a supervision and control department within the Ministry of Finance controlling the SRS regarding accounting company licensing and the AML/CTF certification process.
6. Perform an evaluation of knowledge and adequate qualification of SRS employees prior to beginning company licensing and AML/CTF qualification certification.
7. If necessary, impose an obligation on the SRS to attract external specialists with adequate qualifications or a company that will provide support and training on the provision of such services in the initial stage, ensuring parallel training of SRS staff, involving them in all processes of company licensing and AML/CTF qualification certification.
8. Establish an inspection of work in the relevant SRS department, evaluating the work results thereof and appropriate knowledge of employees while starting to work in autonomous mode without involving specialists from outside.
9. Establish by law that the directors of the SRS administration and the anti-money laundering agency chief are appointed for a fixed term, which they may spend in one position. There could be two terms of four years each.
10. Establish more stringent control over the timely filing of Suspicious Transaction Reports, ensuring legal support to whistle-blowers, protecting them from possible complaints of third parties and litigation due to provision of information to the SRS.
11. Introduce an assessment of the supervising institutions based on ISO 19011:2018 standards, including auditing management systems, the principles of auditing, managing an audit programme, and conducting management system audits.
12. For companies at increased risk, implement the Anti-Bribery Management System (ABMS) and a Compliance Management System (CMS) according to ISO 37001 and ISO 19600.

Conclusion

Latvia is currently about to face great challenges in successfully handling the AML area as expected by its European and global partners as well as supervising authorities. At the same time, Latvia may prove to all its partners that it is and will continue to be a stable and safe partner. While facing serious issues related to AML/CTF due to its geopolitical layout, Latvia has an opportunity to prove to the world that it is able to form one of the most stable and safe AML/CTF control systems and also consult other countries in these matters.

This white paper has come to the following conclusions:

1. The approach to AML/CTF must be changed by shifting the concentration from the financial sector to the accounting company sector, combating non-compliance in the initial stage, and establishing mandatory requirements to use accounting company services in high-risk sectors.
2. More stringent control measures must be introduced regarding the understanding of AML/CTF at accounting companies and the SRS as the supervising and controlling authority.
3. More stringent control measures must be introduced in respect of accounting companies' compliance with the requirements of the PAMLTF Law and Cabinet Regulation No. 674 and the practice of applying harsher penalties for violations.
4. A monthly reporting and single accounting system must be introduced to improve the quality of reports submitted and control over the operation of shell companies and inactive companies.
5. The importance of AML/CTF conformity should be explained to a broader spectrum of society, making it a popular public movement.

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