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Role of Auditors in Reducing Effects of Money Laundering: Concept Paper

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Abstract

Money laundering has always been an issue not only to Malaysia but also around the world. Generally, the Government of Malaysia has enacted the anti-money laundering act as required by the Financial Action Task Force (FATF) in response to combating the money laundering issue. This paper ascertains the roles of auditors in reducing the effect of money laundering in terms of economic, social, and politic. By having the understanding, the recommendations are proposed to reduce the effect of money laundering and at once mitigate the money laundering activities through the job scope of auditors. Therefore, this study is focused on the roles of audit committees, internal auditors, and external for understanding to prevent money-laundering activities. This study also refers to International Auditing Standard; Section 600, 610, and 620. Additionally, this paper provides awareness to the reader on how money laundering could affect the country's sustainability through the economic, social, and political aspects.

Keywords: Effects of Money Laundering, Economic, Social, Political, Administrative, Roles of Auditors, Internal Auditor, Audit Committee, and External Auditor.

Introduction

According to the European Committee Manual for Money Laundering, published in 1990, money laundering involves the transfer of ill-gotten money obtained through criminal activities (Aslani et al., 2011). After that, that money will be mixed in with legal money to hide the illegal origin of this money and to avoid the legal responsibility that would otherwise result from the consequences of such illegal activity. Money laundering generally involves hiding the source of money earned through illegal activities such as drug trafficking, corruption, embezzlement, or gambling by converting it into a lawful source. Besides, it can also be defined as fraud and deception involving financial resources to obtain financial gain from an individual or business.

Money laundering is a series of multiple transactions used to conceal the source of financial assets so that those assets can be used without jeopardising the criminals who want to use them. According to Bank Negara Malaysia, these transactions commonly fall into three stages. The first stage is placement which involves the process of placing unlawful funds into a reporting institution through deposits, currency exchange, wire transfer or other means. The second stage is layering which involves using multiple layers of transactions to separate illegal funds from their illegal sources. This is done to obscure or make it difficult to trace the illegal funds' origin. The third stage is integration. Integration stage is where the illegal funds have successfully integrated or disguised into the economy appearing as legitimate funds (Sanusi et. al., 2016)

Auditors play an essential role in the management of financial statements. They are responsible for ensuring that all transactions and information are recorded accurately and that there is no fraud or misstatement. They have to ensure that no suspicious transactions occur, which can result from fraud or other fraudulent activities. This means that the audit profession's starting point for the examination and reporting responsibility should be how an audit is frequently performed, whether or not it adheres to good audit practice and professional codes of ethics. As such, an auditor is not compelled to seek out wrongdoing aggressively. Instead, if an auditor discovers circumstances that raise suspicions of money laundering operations while carrying out his or her mission, the concern exists after further investigation. In that case, the auditor should report these suspicions to the police.

Background of The Study

The main objective of this study is to understand the roles and responsibilities of auditors in preventing and reducing the effects of money laundering, especially in Malaysia, where many companies and financial institutions have been involved in illegal activities. Besides, it will also look at how they can be used to reduce the impact of money laundering and other illegal activities on a few aspects, such as the economy, society, and politics. Based on the statistics from Royal Malaysian Police, money laundering is the top three crime case in Malaysia for the year 2021, with 847 cases (Department of Statistics Malaysia, 2022). They expect cases to increase yearly (Bernama, 2022). One of Malaysia's most popular cases related to money laundering is 1 Malaysia Development Fund Bhd (1MDB), which amounted to over RM2.67 billion (approximately US$700 million) (Department of Statistics Malaysia, 2022).

Finally, this study will also identify areas for improvement in anti-money laundering regulations and possible solutions for enhancing their effectiveness in reducing money laundering and other criminal activities in Malaysia. Several different regulatory bodies in Malaysia investigate and prosecute cases of money laundering, such as the Royal Malaysian Police, Securities Commission, Malaysia Anti-Corruption Commission, Ministry of Finance, and many more. In addition, in Malaysia, the government has enacted the Anti-Money Laundering, Anti-Terrorism Financing, and Proceeds of Unlawful Activities Act 2001. The act was one of the efforts by the Malaysian government to combat money laundering activities in Malaysia

Problem Statement

Money laundering is a crime, justified by the fact that whoever laundering money is pursuing a way to legitimise their ill-gotten gains, which are accumulated via illegal activities, and it allows criminals to enjoy the proceeds of their crime (Baldwin, 2003). The occurrence of money laundering has become a big problem for the country.

Money laundering has an adverse impact on the economy and political stability of a country; hence, such an activity must be curbed with an iron fist (Vandana, 2012). The auditor's role is to provide "reasonable assurance" about whether the financial statements are free from material misstatement due to fraud, and the new standard requires additional professional skepticism, better risk assessment, and a requirement to remain alert to fraud during their work (AB Magazine, 2021).

The effects of money laundering are severe and extensive. It can create global and local impacts on businesses, economies, and societies (Sanus et. al., 2016). This impact can be lessened with early involvement in the internal control of a country. An audit of financial statements may help counter such crimes as fraud, corruption, and money laundering (Accountancy Europe, 2017). Auditors are responsible for handling internal control to prevent any fraud or misstatement from happening. Each of them has its role in guarding the financial security of a country without affecting important aspects.

The Gap in Research

A few research and studies have been published related to Effects of Money Laundering. Firstly, there was a research of money laundering cases under the Enforcement of Malaysia Central Bank (Sanusi et al., 2016). The article focused on Bank Negara Malaysia as the central agency of the enforcement of the Anti-Money Laundering and Terrorist Financing Act (AMLATFA) 2001. Another study from the Republic of Iraq and the Republic of Iran found the effects of internal auditing in combating money laundering (Al-Safawi et al., 2022). The study reviews the stages of money laundering operations and the concept of internal auditing in combating money laundering. There is also a study that focuses on the roles of the auditing profession in fighting against economic and financial crimes (Aslani et al., 2011) by students from Islamic Azad University, Iran. The study focused on the roles of auditors in fighting against many types of financial crimes, such as fraud, tax evasion, and money laundering. As of the date this study reported, there are a few studies issued focusing on the negative effects of money laundering. However, our study will focus on the effects of money laundering economically, socially, politically, and administratively with the roles of auditors in reducing the effects. The difference between our study compared to many studies done before ours is that we will include the roles of auditors specifically, which are, the audit committee, internal auditors, and external auditors in fighting against money laundering crime.

Literature Review: Effects of Money Laundering Crime

Economic Effects

The issue of money laundering has been a big and sensitive topic in the world. The effects of money laundering on economic development are difficult to enumerate, but such activity damages the financial sector institutions that are critical to economic growth and reduces productivity in the economy’s real sector by diverting resources and encouraging crime and corruption, which slow economic growth and distort the external economic sector (Idowu & Obasan, 2012).

Money laundering can have a negative impact on the economic growth rate of a country. Financial instability in the country can cause the real-estate sector to suffer significantly, making it necessary for companies to have foreign investors, even though there is no easy way to attract them to invest in money laundering countries. Because the price instability caused by black money in the financial system will affect the economy's credibility in the external environment, rational entrepreneurs will find it inconvenient to invest in the country because they will also consider the country's risk while investing. Investment rates will cease to increase if legal money manages to escape and leave the country. As a result, sustainable long-term growth will slow.

Money laundering can also affect the economy because of artificial price growth. Money launderers are encouraged to invest their income illegally to become legitimate (Gjoni et al., 2015). Thus, they are willing to pay for the shares that are priced higher than their real value, which leads to price instability through an artificial increase in the prices. Money launderers make large purchases, and because of their greater access to funds, they outnumber potentially honest buyers. In order to hide their illegal funds, they can pay much more than the true value of the property, causing an artificial movement of purchases, making them unaffordable by honest buyers, and henceforth affecting the economy of a country.

Money laundering, amongst other economic and financial crimes, is a source of reduction of government revenue (Moodley, 2008). In fact, the occurrence of money laundering, together with other economic and financial crimes, has reduced government tax revenue. Moodley, (2008) stated in her article that money laundering and its predicate offenses are factors that contribute to the tax gap. Income that comes from illegal money is the earnings that countries do not tax, and this will result in reductions in tax revenue for the government. Tax income holds the largest portion of all public revenues, and when it falls, it will result in budget deficits, which will negatively affect the economy.

Social Effects

Money laundering activity also contributes to the negative social impact on a country. It would become a huge concern when money laundering would lead to the extent of social disintegration. According to Klitgaard (1995), Social disintegration is a vague and obviously problematic concept, which presumably refers to such dimensions as conflict and instability, breakdowns in political and civil rights, crime, and violence, growing divisions between rich and poor, and eroding levels of citizens' satisfaction with their lives.

Continual Money laundering without any prevention will open the sheer portal for the criminal to expand their illegal activities widely. According to McDowell and Novis (2001), money laundering has a significant adverse effect on social well-being. The risks of money laundering in terms of social security are that it allows the criminals to expand their operations and drives up the government costs to expand law enforcement as well. (McDowell & Novis, 2001). If the practice of disguising illegal activities becomes the norm it will give economic challenges to other legal businesses to compete against the business with disguised illegal funds. For example, in the United States, organised crime with illegal activity which as heroin trafficking disguised their activities as a transaction under the pizza parlours business. The pizza parlours act as front companies which receive illegal funds to subsidize their products to be marketed below the market price. Therefore, unfortunately, the easiest way to level up their economic growth is to join the criminal net. In consequence, money laundering becomes increasingly widespread which also increases the potential of the social disintegration of a country.

Money laundering activities have the power to become the root of civilization or societal collapse. Without proper undertaking methods, prevention, and law, money laundering is capable of changing citizens into criminals and dooming the reputation of a country. The increase in crime will make the citizens struggle to survive morally and ethically. This is what begins the breakdown of the society called social disintegration. The economic and social distress will eventually add fuel to the increase of crimes domestically and globally. According to McDowell & Novis (2001), money laundering could affect socioeconomic negatively as money laundering is able to transfer economic power from the market, government, and citizens to criminals. Hence, good governance should be established to combat the money laundering practice in a civilised country. Besides that, to ensure the effectiveness of the governance, the authorities involved must serve their responsibilities competently and with full integrity. The authorities involved should not be biased and be honest throughout their service.

Administrative and Political Effects

Money laundering can be a destructive factor in administration and politics. Administration and political impacts mean the effects of money laundering on the government or public affairs of the country. Money laundering allows criminals to weaken the political stability of states by using ill-gotten money to finance illegal and criminal operations (Al-Safawi et al., 2022, 4). The stability of politics can be weakened due to the gap in security and then becomes a threat to a state. A state's organisation's security defences weaken as criminals are able to launder money without getting caught and expand their criminal activities (Al-Safawi et al., 2022, 5). The vulnerability of financial institutions increases as crime increases which strengthens the criminals and money laundering channels. For example, financial institutions will face a risk resulting in the loss of public trust due to bad publicity (Taylor, 2020). Organised crimes like money laundering can criminally infiltrate financial institutions and then offer bribes to public officials, who hold power in government. Corrupted officials and influential individuals who inject dirty money into the political and economic structure of a country destroy the balance in financial markets and volatility funds in banks and financial institutions (Poormazahaer et al., 2013).

The influence of money laundering criminals can affect democratic countries by damaging the integrity of the entire society (Patel & Thakkar, 2012). As a result of money laundering, corrupted politicians, officials, and influential individuals can easily inject dirty money and enormous illegal income into a political structure. When criminals successfully launder huge amounts of money, businesses and the public would easily be persuaded to jump on the criminal bandwagon (Taylor, 2020). Political impacts relate to economic impacts when foreign investors are least likely to invest in a state due to unstable politics. Unstable politics can be caused by money laundering activities due to poor quality of governance. According to a study conducted by a group of researchers, as the chances of a government collapsing increase, the economic growth of a country will decrease (Alesina et al., 1996).

Roles of Auditors in Reducing the Effects of Money Laundering

The roles of auditors relate to corporate governance whereby auditors need to oversee activities undertaken by the board of directors and audit committee to ensure the integrity of the financial reporting process. Three parties can play part in reducing the effect on politics, which are the audit committee, internal auditors, and external auditors.

Audit Committee

An audit committee plays an active role in overseeing the financial reporting and governance processes (Clayton et al., 2019). The role is discharged by assisting directors in discharging their statutory duties. An audit committee is involved in decision-making by making sure the directors are aware of their liability in preparing the company's financial statements (Australian Securities & Investments Commissions, 2021). Besides that, the audit committee also monitors the company's activities by having access to the accounting record to monitor the activities planned by the directors (Australian Securities & Investments Commissions, 2021). The audit committee is also responsible for increasing public confidence as they ensure the credibility and objectivity of financial reporting (Leka, 2019). The audit committee is also in charge of satisfying the board that internal control exists and is effective. The audit committee provides assurance of an effective internal control framework on the safeguarding of resources, economical use of resources, reliability, and integrity of the information provided, and compliance with policies, plans, procedures, and laws (Leka, 2019). By discharging their roles as audit committees, they are preventing and reducing fraud while creating effective ethics and compliance awareness (Vollmer, 2016).

Fraud is prevented through careful monitoring of the company's activities as the audit committee has full and unrestricted access to any information pertaining to the company. The audit committee has the power to review any related party transaction that may have shown a conflict of interest. Therefore, if there are any signs of money laundering, the audit committee can review the transaction since they are responsible for ensuring credibility, transparency, and accountability of the financial statements (Vollmer, 2016). The directors will become more aware of their accountability through liability awareness and will be less likely to commit money laundering. Thus, the bad effects of money laundering can be reduced from the active roles of the audit committee.

Internal Auditors

The role of internal audit is vital in the elimination of money laundering. Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. "It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (Baldwin, 2003).

Internal auditors must identify the risk of the possibility of fraud being committed by the company by assessing the control of funds circulating (Ideagen, 2021). Depending on the nature and size of their business, auditors may use a variety of methods to assess money laundering risk. Whatever methods they use, either in evaluating their own risks or those of the client, they should be proportional to the size and nature of the business. They are also required to document the method and the rationale for adopting the method.

Next, internal auditors should check suspicious transactions. By nature, suspicious transactions are more complex and obscure (Ideagen, 2021). Internal auditors should get to the bottom of these transactions to ensure they are genuine and should not check them off their list unless they are completely convinced about their purpose. Enhanced due diligence measures should be taken for non-face-to-face business transactions when the customer has not been seen or the business site has not been visited.

The internal auditors must have a superior level of theoretical knowledge and practical experience to successfully accomplish their role. They must know the possible fraud schemes and scenarios that are specific to an organisation's field of work, for example, insurance, retail, or telecommunications, and be able to recognise the signs of a possible fraud scheme (Petraşcu & Tieanu, 2014).

External Auditors

In combating money laundering, external auditors also should maintain professional scepticism throughout the audit process. It is to ensure the auditor is able to detect any fraud or illegal activities of the client (Accountancy Europe, 2017). Money laundering is a hidden activity and hard to detect. The existence of a Professional scepticism attitude will enable the auditor to always be meticulous in assessing and reviewing the financial statement of the client. Other than that, professional scepticism will ensure the external auditors are alert to any information that shows signs of material misstatement due to fraud committed to conceal the money laundering activities. Hence, the external auditor will be able to provide a reasonable assurance stating the financial statement is free from material misstatement.

The external auditor should understand the client and the business environment of the client (Accountancy Europe, 2017). The auditor should investigate the background and business activities of the audit client and accept the audit engagement that he is competent to perform. It explained that the auditor should know the possible threats of auditing the client and the auditor should implement the safeguards. The safeguards are important for the external auditor to understand the nature of the client’s business and industries. This will help the external auditor to be more critical in reviewing the client's financial statement. At once, the knowledge about the client’s business and industries will increase the professional scepticism as discussed before.

Other than that, the external auditor should lodge a report to appropriate authorities to address the non-compliance of the client to the law and regulation. In Malaysia, this responsibility is explained under section 360 of MIA by laws. Meanwhile under the anti-money laundering act, the external auditor should report the material information of the offence committed to the regulatory. However, the auditor should know what material information should be disclosed for the report unless it is required by the court or Ministry of Finance. The auditor should make a report especially when detecting any indicators and signs of fraud and money laundering.

Conceptual Framework

Figure 1 illustrates a conceptual framework to reduce the negative effects of money laundering. It demonstrates the negative effects of money laundering and the roles of auditors in fighting against money laundering. The negative effects are divided in three perspectives and there will be three parties of auditors who should discharge their roles in reducing the effects.

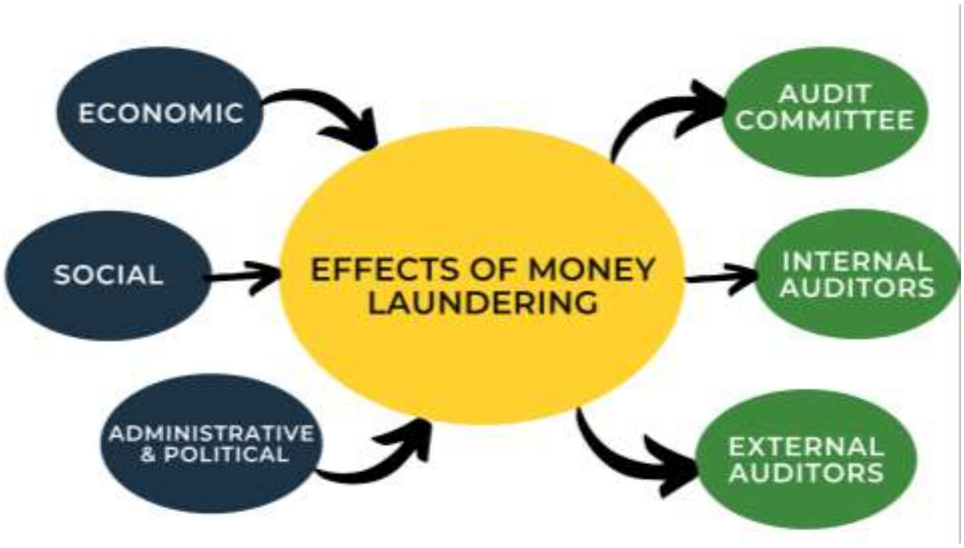

Figure 1: The Proposed Conceptual Framework to Reduce Effects of Money Laundering

Auditors' awareness of their roles in reducing the negative effects of money laundering should be raised in order to fight against money laundering crimes. The roles of auditors to provide a credible presentment of financial statements will help in reducing the crimes. Proper knowledge on the roles they hold will reduce the number of money laundering crimes in Malaysia.

Recommendations

Measures need to be taken to combat money laundering as it has become one of the top three crime cases in Malaysia for the year 2021 (Department of Statistics Malaysia, 2022). Money laundering is expected to increase over the years (Bernama, 2022) causing the bad effects to increase as well. Thus, preventive action must be taken by discharging the roles of auditors in controlling the activities that might lead to money laundering. The reduction of money laundering activities can be achieved if more auditors become more responsible in ensuring the integrity and credibility of financial statements disclosed. The auditors play a vital role in controlling organisations by proper monitoring of records and activities to avoid any potential crime being committed. The government can prioritise the importance of clarity, integrity, and credibility of financial statements by making it compulsory for companies to have audit committees that oversee the financial reporting and governance processes.

Conclusion

Money laundering has become a global problem and needs global concerns. This paper has discussed the impact of money laundering on the economic, social, administrative and political aspects, also the roles of auditors including the audit committee in reducing the effects of money laundering. Auditors need to do their best in preventing and reducing the occurrence of more money laundering from happening. All these three parties, Audit Committee, Internal Auditors and External Auditors are responsible to do and commit to each of their roles. The audit committee should monitor compliance with the policies and procedures established to prevent and detect money laundering. This can include reviewing reports on customer due diligence, transaction monitoring, and suspicious activity reporting. While, Internal auditors should review the organization's controls to prevent and detect money laundering, including customer due diligence, transaction monitoring, and suspicious activity reporting. This can involve testing the effectiveness of these controls and identifying any weaknesses or gaps that need to be addressed. In other perspectives, external auditors should evaluate the organization's controls to prevent and detect money laundering, including customer due diligence, transaction monitoring, and suspicious activity reporting. This can involve testing the effectiveness of these controls and identifying any weaknesses or gaps that need to be addressed. In conclusion, when all parties are working together to prevent money laundering, those activities can be controlled from given a big impact on our economy.

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