



# Is the public sector prepared to identify and prevent the risks of money laundering and breaches of sanctions?

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## Audit report

Is the public sector prepared to identify and prevent the risks of money laundering and breaches of sanctions?

11 October 2021

Compliance audit “Compliance with the requirements of the Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing (AML/CTPF Law) and the Law on International and National Sanctions of the Republic of Latvia in the public sector”.

The audit was performed based on audit schedule No 2.4.1-41/2020 of the Fifth Audit Department of the State Audit Office of 7 September 2020.

The cover design includes an image from the website *www.depositphotos.com*.

## Dear Reader,

In this audit report, we are not talking about what some institution has not done or could have done better. Our goal is to reflect the current level of preparedness of the public administration to prevent the risks of money laundering and sanctions and to support the public administration to increase this level in time for any further negative consequences to occur.

Although the focus of anti-money laundering in our country has been on the financial sector so far, it is by no means the only area where one should strengthen the protection against the risks posed by 'dirty' money.

Given the circulation of lump funds in state and municipal institutions and state-owned enterprises, one must be aware that the risks of money laundering and risks of cooperation with individuals included in the lists of international or national sanctions are significant. Ignoring or failing to address those risks in time both threatens to damage the reputation of public administration, and cause losses to the state and municipal budgets, and hinder the provision of essential state and municipal services to the population.

The twists and turns of financial systems used to launder money and escape the restrictions of international sanctions are complicated, and it is only natural that people who do not work with it on a daily basis might not understand them. This audit confirms that the experts from state and municipal institutions need support to develop a comprehensive internal control system and provide effective protection against the risks of money laundering and sanctions. By support, I mean training tailored to the specifics of public administration, as well as guidelines and other aids, and digital support tools embedded in public administration processes.

We are really satisfied with the responsiveness of the employees of the state and municipal institutions witnessed during the audit and their readiness to take the necessary measures to improve the operation of the institutions. It creates confidence that the protection of the public sector against the occurrence of adverse consequences

will be strengthened significantly in the near future with the goodwill of Latvia as a country where the rule of law, transparency, and dignity reign being strengthened at the same time.



Warren Buffett once has said that it takes 20 years to build a reputation, but five minutes is enough to destroy it. Everyone must remember that, especially if the reputation of not only the individual but also a municipality, an industry, or even the whole country is at stake.

I thank the experts of the Financial Intelligence Service, the Financial Industry Association, and the Ministry of Foreign Affairs for their support in gaining a comprehensive understanding of the specifics of the field concerned and the representatives of all ministries and other state and municipal institutions for their excellent cooperation during the audit!

Special thanks to the municipal internal auditors with whom we conducted this audit. You were an important part of our audit team! I expect this is just the beginning of our even greater cooperation in the future.

Respectfully

Edgars Korčagins  
Department Director

A handwritten signature in dark ink, consisting of stylized initials and a surname.

## Summary

### Motivation

The prevention of money laundering and terrorism and proliferation financing (hereinafter – AML/CTPF), as well as the observance of international and national sanctions has been a topical issue both in Latvia and in the world for several years. The public sector is also at risk of being exposed to ML/TPF schemes or the individuals subject to sanctions.

According to the European Commission's transnational ML/TPF risk assessment<sup>1</sup> published in 2019, potential money launderers are focusing on the non-financial sector increasingly such as manufacturers, distributors, legal service providers, and various non-financial institutions. Studies show that 20-30% of illicit proceeds are laundered through the non-financial sector, so the European Commission generally considers the risk exposure of non-financial sectors significant<sup>2</sup>. In addition, both the risks of ML/TPF and sanctions can be interlinked, for example, shell companies can be incorporated, information on transfers and real estate owners can be hidden to circumvent the sanctions imposed.

Latvian public administration institutions and local and regional governments are also increasingly confronted with issues and uncertainties regarding the application of the requirements of the AML/CTPF and sanctions. Moreover, the violations of the laws and regulations regulating the domain of AML/CTPF and sanctions can significantly affect the reputation of both specific institutions and the country as a whole. Therefore, the public sector must also be aware of the risks of ML/TPF and sanctions and set up an internal control system to manage those risks.

Since 13 August 2008<sup>3</sup>, public authorities, derived public entities, and their institutions are obliged to provide the Financial Intelligence Service (hereinafter - FID) with information on each suspicious transaction. In its turn, the Law on International and National Sanctions of the Republic of Latvia (hereinafter - the Law on Sanctions) is binding on all individuals and legal entities providing for the obligation<sup>4</sup> to observe and enforce international and national sanctions. Thus, public entities must not engage in activities that allow or facilitate the circumvention of the sanctions regime or the avoidance of sanctions.

The audit aimed at assessing the public sector's practice in applying those requirements to ensure the timely detection of suspicious transactions and the avoidance of transactions involving sanctioned individuals, thus avoiding negative consequences for the public.



The audit aimed at proactive assessment of the public sector's practices in assessing the risks of ML/TPF and sanctions and in introducing appropriate internal controls.

## Main conclusions

The public sector requires many improvements to get prepared to identify and address the risks of money laundering and sanctions (See Figure 1).

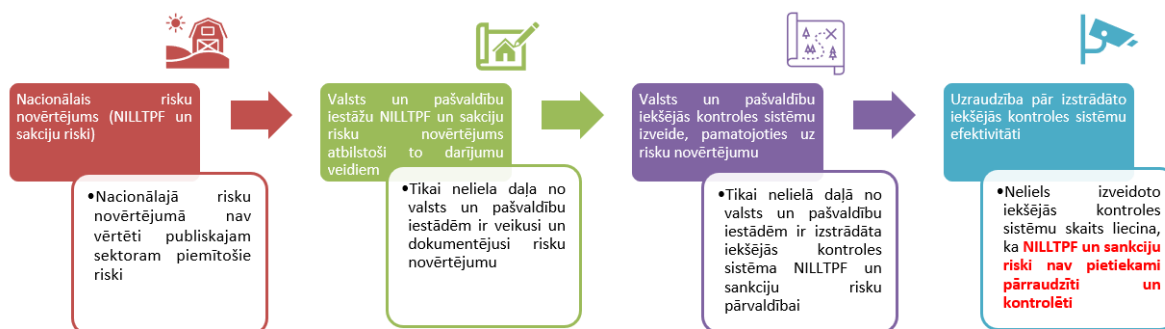



Figure 1. Best practice example of AML/CTPF and sanction risk management and audit findings.

In the national risk assessments performed in Latvia, the current risks in the public sector have not been directly assessed and analysed so far, and the public sector does not have a common understanding of the importance of AML/CTPF and sanction risk management and practical actions.

Publicly available information on cases where the public sector has not been prepared to react and act promptly evidences the latter. In 2018, Municipal JSC “Daugavpils Satiksme” of Daugavpils City purchased trams manufactured in the Russian Federation. The situation initially raised concerns both about the risk of losing the EU funding and the breaches of international sanctions, wherefore the competent authorities carried out inspections, which did not reveal any irregularities<sup>5</sup>. In 2019, the US Office of Foreign Assets Control (hereinafter - OFAC) imposed<sup>6</sup> sanctions on Aivars Lembergs and several organisations. In 2020, JSC “Pasažieru vilciens” encountered problems in purchasing spare parts for diesel trains, as their manufacturer was subject to OFAC sanctions. In February 2021, the SRS Tax and Customs Police Department initiated criminal proceedings against *Erbauer group* Ltd for large-scale money laundering<sup>7</sup>. The company belongs to the Councillor of the Jekabpils City Council, and it has won the procurements organised by the Jekabpils City Council, the Madona Regional Government, the Food and Veterinary Service, state-owned “Latvijas Valsts ceļi” Ltd, and other public entities, including procurements related to projects financed by EU funds<sup>8</sup>. In April 2021, a ship entered the Port of Liepāja



for repairs, whose owner was included in the OFAC sanctions database<sup>9</sup>.

The European Commission emphasises<sup>10</sup> that non-financial sectors are also exposed to risks, including a number of areas that could be subject to AML/CTPF requirements in the future, such as free ports.

The audit has concluded that the amount of transactions exposed to the risk of ML/TPF and breaches of sanctions is high and that breaches can affect both the country's goodwill and economic growth, and the availability and quality of services provided to population.

The auditors have identified at least five areas of risk in the public sector where local and regional governments, ministries, and central authorities can potentially face risks of ML/TPF and breaches of sanctions: transactions with NGOs, public procurement, transactions with politically exposed persons, foreign transactions, and expropriation of real estate. A significant amount of public funds is circulating in those areas, that is, the amount of public procurement contracts reached 311,696,157 euros, the amount of foreign contracts - 12,150,179 euros, the amount of real estate expropriation transactions - 11,706,020 euros, and transactions with non-governmental organisations (hereinafter - NGOs) - 3,932,887 euros in the 18 local and regional governments included in the audit sample alone in 2020.

There is no common understanding in the public sector about the measures required for AML/CTPF risk management and their level of detail. Only four of the 18 local and regional governments included in the audit sample and only two ministries and two institutions out of the 25 authorities included in the audit sample have carried out and documented at least a partial risk assessment of the ML/TPF and/or sanctions.

The situation is similar regarding the internal control systems for AML/CTPF and sanctions risk management: internal control systems are not implemented in most local and regional governments and institutions, or only some elements of them are in place.

Only five local and regional governments and two institutions have internal control systems covering AML/CTPF domain, which include directly applicable procedures for the examination of counterparties. The small number of reports submitted to the FID from public entities about suspicious transactions indicates that public entities perhaps are not able to identify suspicious transactions in the area of AML/CTPF and sanctions and report to the FID for further investigation.

In its turn, in the area of sanctions, there are inspections carried out only in public procurement, and only six public entities included in the audit



sample have determined the procedure for performing sanctions inspections and the officials in charge. In addition, irregularities in compliance with the requirements of the Sanctions Law have been identified in local and regional governments, ministries, and central institutions.

The assessment performed by the State Audit Office shows that the public sector does not have sufficient methodological support in the form of training, guidelines or other types of methodological/informative activities. To facilitate a common understanding of the AML/CTPF and sanction risk management, there is a need for support measures tailored to the specificities of the public sector and providing practically applicable information on best practices and a minimum set of actions to be taken in risk management.

## Key proposals and recommendations resulting from the cooperation

For boosting a common understanding of the risks of the ML/TPF and sanctions and to support the development of internal control systems in the public sector, the auditors made recommendations to the competent authorities of the AML/CTPF and sanctions to identify risks characteristic for public administration, provide methodological support and training to the public sector, and to improve the access to databases and their functionality to ensure proportionality in inspections and reduce the use of administrative resources.

As different authorities are involved in the development and implementation of the AML/CTPF and sanctions policy, the audit proposals are differentiated according to their roles and responsibilities to facilitate the systematic management of the ML/TPF and sanctions risks in the public sector.

There are proposals made to the FID related to public sector risk assessment and analysis, and both the FID and the Ministry of Foreign Affairs are recommended to provide methodological support to the public sector and organise public sector-specific training in cooperation with the State Chancellery. In its turn, there are proposals made to the Ministry of Environmental Protection and Regional Development related to the improvement of the functionality of the Electronic Procurement System.

During the audit, the State Audit Office also cooperated with internal auditors of local and regional governments by applying the methodology prepared, audit approach, working documents, and



To ensure the timely detection of suspicious transactions and to avoid cooperation with sanctioned persons, the public sector must raise awareness of the ML/TPF and sanctions risks, improve methodological support and access to information resources, and improve internal control systems through a risk-based approach.

informative materials on ML/TPF and sanctions risk assessment and management in the public sector by the State Audit Office.

Municipal<sup>11</sup> internal auditors drafted reports<sup>12</sup> on the results of the internal audits performed in the local and regional governments, revealing the conclusions and providing 37 recommendations<sup>13</sup> to eliminate irregularities:

- ④ Leaders of local and regional governments, whose institutions had the internal control system for ML/TPF and sanctions risk management identified, are invited to improve it by:
  - ✓ Performing the institution's ML/TPF and sanctions risk assessment in accordance with existing best practice;
  - ✓ Amending the job descriptions of the responsible employees, including the obligations to perform AML/CTPF and sanctions risk management inspection procedures by defining their duties and responsibilities;
  - ✓ Stipulating a mandatory requirement of documenting the inspection procedures of AML/CTPF and sanction risk management;
  - ✓ Ensuring that all contracts entered into by the institution include a clause on the institution's right to unilaterally withdraw from the contract if it becomes unfeasible due to the sanctions imposed (for example, to provide for additional controls during the annual stock-taking);
- ④ Leaders of local and regional governments, whose institutions do not have a risk-based internal control system for AML/CTPF and sanction risk assessment identified, are invited to introduce such system to ensure compliance with the requirements of the AML/CTPF Law and the Law on Sanctions;
- ④ Leaders of local and regional governments are invited to provide staff training in accordance with the duties and responsibilities of each involved.



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- 1 REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the assessment of the risk of money laundering and terrorist financing affecting the internal market and relating to cross-border activities, Brussels, 24.7.2019 COM(2019) 370 final, page 3. Available: [https://ec.europa.eu/info/sites/info/files/supranational\\_risk\\_assessment\\_of\\_the\\_money\\_laundering\\_and\\_terrorist\\_financing\\_risks\\_affecting\\_the\\_union.pdf](https://ec.europa.eu/info/sites/info/files/supranational_risk_assessment_of_the_money_laundering_and_terrorist_financing_risks_affecting_the_union.pdf), viewed on 10.02.2021.
  - 2 REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the assessment of the risk of money laundering and terrorist financing affecting the internal market and relating to cross-border activities, Brussels, 24.7.2019 COM(2019) 370 final, page 3. Available: [https://ec.europa.eu/info/sites/info/files/supranational\\_risk\\_assessment\\_of\\_the\\_money\\_laundering\\_and\\_terrorist\\_financing\\_risks\\_affecting\\_the\\_union.pdf](https://ec.europa.eu/info/sites/info/files/supranational_risk_assessment_of_the_money_laundering_and_terrorist_financing_risks_affecting_the_union.pdf), viewed on 10.02.2021.
  - 3 Article 3.<sup>1</sup> of the Law on the Prevention of Money Laundering and Terrorism and Proliferation Financing. The legal provision was originally included in Section 3.4 of the said Law
  - 4 Section 2.2 of the Law on International and National Sanctions of the Republic of Latvia.
  - 5 Available: <https://jauns.lv/raksts/zinas/302369-kapec-daugavpils-par-eiropas-naudu-perk-tramvajus-no-krievijas>, <https://nra.lv/latvija/261794-arlietu-ministrija-neslepj-nepatiku-par-daugavpils-velmi-iepirkt-tramvajus-krievija.htm>. Viewed on 08.03.2021.
  - 6 Available: <https://www.mfa.gov.lv/arpolitika/par-eiropas-savienibas-ierobezojosiem-pasakumiem/asv-sankcijas>. Viewed on 05.02.2021.
  - 7 Letter No VID.4.1/15.5.4/9101 of the State Revenue Service of 15.06.2021. See also, for instance: <https://www.lsm.lv/raksts/zinas/latvija/vid-izmekle-jekabpils-domniekam-gavrilovam-piederosauznemuma-iespejamas-nelikumibas.a404193/>. Viewed on 12.05.2021.
  - 8 *Lursoft* data – data of the Procurement Monitoring Bureau in which a company has been approved as a supplier. See also, for instance, <https://www.lsm.lv/raksts/zinas/latvija/parbaudis-iepirkumus-saistiba-ar-jekabpils-domnieka-uznemumu-.a404687/>
  - 9 Minutes of the interview of the State Audit Office and the Ministry of Transport of 17.08.2021. See also, for example: <https://www.lsm.lv/raksts/zinas/latvija/liepajas-sez-noliedz-parkapumus-osta-ielaizot-asv-sankcioneta-ipasnieka-kugi.a400251/>; *Liepājas ostā ienācis ASV sankcijām pakļauta īpašnieka Krievijas kuģis - DELFI*. Viewed on 12.04.2021.
  - 10 REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the assessment of the risk of money laundering and terrorist financing affecting the internal market and relating to cross-border activities, Brussels, 24.7.2019 COM(2019) 370 final, page 3, 5-6. Available: [https://ec.europa.eu/info/sites/info/files/supranational\\_risk\\_assessment\\_of\\_the\\_money\\_laundering\\_and\\_terrorist\\_financing\\_risks\\_affecting\\_the\\_union.pdf](https://ec.europa.eu/info/sites/info/files/supranational_risk_assessment_of_the_money_laundering_and_terrorist_financing_risks_affecting_the_union.pdf), viewed on 10.02.2021.
  - 11 The audit sample of local and regional governments was formed in accordance with the administrative-territorial division in 2020, but, taking into account the administrative-territorial reform, the provided recommendations are binding on the newly established local and regional governments. Although recommendations were made to the local and regional governments included in the scope of the audit, the actions identified in them to improve the AML/CTPF and sanction risk management are also relevant to other public sector entities, including state and municipal institutions not included in the audit sample.
  - 12 The Daugavpils Regional Government, the Jūrmala City Municipality, the Liepāja City Municipality, the Limbaži regional Government, the Madona Regional Government, the Rēzekne City Municipality, the Saldus Regional Government, and the Valmiera Regional Government.
  - 13 One recommendation was given to the Daugavpils Regional Government, two recommendations to the Jūrmala City Municipality, eleven recommendations to the Liepāja City Municipality, four recommendations to the Limbaži Regional Government, four recommendations to the Madona Regional Government, three recommendations to the Rēzekne City Municipality, nine recommendations to the Saldus Regional Government, and three recommendations to the Valmiera Regional Government.