

FINANCIAL INVESTIGATION and FORENSIC ACCOUNTING

Second Edition

George A. Manning, Ph.D., C.F.E., E.A.

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Preface

Forensic accounting can be defined as the science of gathering and presenting financial information in a form that will be accepted by a court of jurisprudence against perpetrators of economic crimes.

Economic crimes have increased dramatically in recent years. This becomes evident in viewing newspaper reports, which on an almost daily basis report of economic crimes committed in communities across the country. One can read of a person embezzling funds from a bank or company, a political person accepting kickbacks for political favors, a con artist who swindles people out of money by fraudulent schemes, or a person selling illegal products (drugs, alcohol, or tobacco).

Law enforcement personnel in recent years have become more aware of white-collar crimes. However, they have lacked the training and expertise in combating such crimes. This is particularly true for small police departments. The law enforcement community today is better trained at combating violent or personal behavior crimes, but now it has the responsibility to expand its knowledge and expertise into the economic crimes area. In order to do this, law enforcement must receive further education and training. Many police departments, both small and large, focus their resources on violent crimes. Since many detectives do not have an accounting background, they often fail to use financial information to support their cases. This is particularly true in organized crime and drug trafficking cases. Congress and some states have enacted laws for law enforcement to use financial information to support their cases. Some large police departments have employed accountants to help law enforcement develop financial information, but they are relatively few. One South Florida police department with over 2000 sworn officers has only one accountant, and he is swamped with cases. Some police departments will contract an accountant for a case, but this is rare.

The accounting profession is beginning to change from examination for irregularities to examination for fraud on the part of employees and management. Some of the largest bankruptcies have occurred during the last 5 years because management has been "cooking the books" to hide their skimming of huge amounts of funds from public corporations. This has resulted in many investors losing their life savings or retirement nest eggs. This, of course, has resulted in a change of audit procedures to encompass external third-party inquiries as well as internal audit procedures. Financial institutions and credit reporting agencies are becoming more involved with business organizations' financial affairs by requiring more disclosures. They are developing more techniques to uncover potential fraudulent schemes by developing profiles, which will identify perpetrators before huge losses are incurred by other businesses.

The cooperation of accountants and law enforcement has now become not just important but imperative. Accountants must know what financial data are admissible in a court

of law. The criminal investigator must learn how to use financial information to enhance his case.

The following illustration gives an example of what the results can be when law enforcement personnel do not have the training and knowledge to use financial information.

A police department in South Florida obtained a search warrant for a car dealership suspected of dealing in drugs. The officers went in and discovered large amounts of cocaine, money, jewelry, precious metals, and financial files. The police officers confiscated the cocaine, money, jewelry, and precious metals, but left the financial files behind. In a forfeiture hearing, the defendants claimed that the jewelry and precious metals did not belong to them and provided witnesses who testified that the jewelry and precious metals were being held on consignment. The court ruled in favor of the defendants, and several days later, the defendants got on a flight out of the country with the jewelry and precious metals in their possession. It was later learned that the jewelry and precious metals were purchased from various vendors in the city. The estimated cost of the jewelry and precious metals was \$1.8 million. The drug traffickers removed their laundered money out of the country by buying jewelry and precious metals since no Treasury Currency and Monetary Instrument Reports (CMIRs) were required at the time. The police would not have lost the jewelry and precious metals if they had confiscated the financial records, which clearly showed how the defendants purchased the commodities.

Accountants in both public practice and industry must recognize financial crimes at an early stage and document such crimes for judicial prosecution. Most accountants do not recognize fraud. Business people do not recognize fraud schemes until it is too late. The following illustration shows how a business became a victim even when advised of the situation.

A major supplier of appliances had a policy of granting liberal credit terms to new businesses. A new appliance store took advantage by ordering a nominal amount of appliances. The new store regularly ordered appliances at an increasing rate using the liberal credit terms. The controller noticed that the rate of increase was above normal. The management of the supplier disregarded the controller's concern. After about 9 months, the new store placed an \$800,000 order, and since the new store paid its bills on time, the order was shipped. The management of the new store received the \$800,000 order and the next day shipped its entire inventory to another location some 300 miles away. When the supplier sent notices to the new store for payment, the notices first came back marked "unclaimed" and later came backed marked "moved with no forwarding address." When the supplier sent collectors out to the new store, they found the building empty. The new store owners disposed of the inventory for \$1.5 million and the supplier suffered a loss of \$800,000, which took 5 years to recover by raising prices by 10%. The supplier unsuccessfully sued the new store. Law enforcement would not proceed against the store owners because they concluded that the new store owners were merely bad businessmen. Actually, law enforcement did not know how to prosecute this kind of crime.

The purpose of this book is twofold. First, it should be used as a reference guide by law enforcement and accountants. This book is written so the reader can find specific issues and learn how to investigate and present them in a court of law. Second, it can be used as a textbook in training both law enforcement and accountants in the field of fraud examination and forensic accounting.

This book is focused upon practical, everyday use by both law enforcement and accountants. Theory is also addressed, but it is explained more in terms of everyday use. Another objective is to make accountants familiar with law enforcement and the law, and law enforcement familiar with the importance of financial information in both civil and criminal cases. It has been made very clear that when a team of both accountants and criminal investigators team up, they rarely lose a criminal case. Also, they learn the inter-relationships and needs of each other.

A trend across this country today is the declining budgets of law enforcement agencies at all levels of government. At the same time, violent crime is on the increase and is expected to increase much more in the future. Public opinion today is for law enforcement to go after violent criminals. Violent crime is on television every day, but white-collar crimes are rarely reported. If this trend continues, then law enforcement will be unable to provide the personnel and other resources needed to investigate white-collar criminals. The FBI reported in the 1990s that violent crime makes up 95% of all cases, while white-collar crime only makes up 5%. Yet, white-collar crime is responsible for 95% of the financial losses suffered by victims.

The security industry has had tremendous growth in recent years. It has made a great demand for security locks, various types of alarms, and security guards. Private investigation firms have also shown tremendous growth, particularly in matters relating to civil litigations, searching for hidden assets, and tracing funds. Some law enforcement agencies have retained private fraud examiners in their investigations. If this trend continues, and the outlook is that it will, fraud examiners will be in greater demand in the future.

The Author

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1.1 Introduction

The effects of crime act upon the economy in two primary ways. Microeconomics deals with the effect on individuals and businesses. Macroeconomics deals with the effect on the local community, national, and international economies. Individuals and businesses can easily understand the effect of crime in their everyday activities. However, most individuals and businesses have difficulty understanding the effect of crime on the community, national, and international levels.

1.2 Cost Reality

The cost of crime on the economy in the U.S. is now at a staggering height. The outlook does not look any better. There is no real compensation for emotional and social harms done to members of a society by criminal acts. The average citizen would be shocked to know the actual costs. There are no consolidated figures as to the total cost of crime. However, if all the various costs were compiled into a consolidated figure, then they would surely be enormous. The cost of crime involves all of the following elements:

1. **Law enforcement.** This encompasses the cost of training and maintaining a police department and all of its support staff, equipment, buildings, etc.
2. **Crime prevention.** This involves all the community programs that try to help prevent crime. Common programs include Crime Stoppers, school programs, and various other programs sponsored by local community tax dollars.
3. **Drug prevention and rehabilitation.** This involves both public and private financing. Both government and private organizations offer programs to prevent and rehabilitate drug and alcoholic offenders. This costs money to both the taxpayers and the patients.
4. **Incarceration.** It costs the taxpayers a lot of money to house, supervise, train, feed, clothe, and provide medical care for inmates in a jail or detention center.
5. **Courts.** Operating and maintaining the court system costs the taxpayers many tax dollars. It involves judges, court reporters, clerks, buildings, etc.

6. **Prosecutors.** The costs of employing prosecutors and their staffs, buildings, and all of the associated costs of operating and maintaining them are enormous, especially in large metropolitan areas.
7. **Public defenders.** Many defendants are not able to afford defense attorneys; therefore, the taxpayers must foot the bill. This bill includes costs of defense attorneys, their staff, and all the costs of operating and maintaining them.
8. **Hospitalization.** A significant cost to society as a whole is health care costs. Medical costs for criminals, victims, and those involved in the justice system are a significant item. With the increase in AIDS and other diseases, this cost has become even more of an attention getter.
9. **Businesses.** Businesses suffer losses when customers or employees steal from them. They have to raise prices or lay off employees because of thefts.
10. **Insurance companies.** Individuals and businesses that have insurance file claims for losses that they suffer from crime. This, in turn, causes insurance companies to raise premiums to individuals and businesses.

The cost of crime can be very high. Some people say that some types of crime do not cost society, i.e., illegal gambling and prostitution. However, you can see that it does cost society. Let us take an example of a simple case. A bookmaker takes bets from his bettors. It is illegal in his area. The bettors are not forced to place bets. They place wagers because they want to “place their money where their mouth is.” Most bettors are middle-class workers. The bookmaker pays off the winners and collects from the losers. When law enforcement makes an arrest after considerable investigation, they must put the bookmaker in jail. The bookmaker usually posts bond or bail and is out after a short period. The bookmaker claims poverty and must retain a public defender. The case goes to trial and the bookmaker is found guilty. He is sentenced to 60 days in the county jail.

The cost to society in terms of money in this example is high. First, the bettors who placed the bets should not have placed bets, since they were using their hard-earned money that should have been used to pay their living expenses. It costs money to the taxpayers to pay the salaries of the investigators and their supporting staff to look into the bookmaker. In addition, it costs taxpayers money to try the bookmaker in court. The judges and their staff have to draw salaries and pay for their expenses. It costs taxpayers even more money to house the bookmaker in jail. The taxpayer has to pay for food and medical costs while the bookmaker is in jail. Also, jailers and correction officers must be paid, along with their benefits, to guard the bookmaker while he is in jail. It costs taxpayers for the detention facilities. The public defender must be paid from public funds. One can see that it costs society in dollar terms even though there is no violence. This example can apply to other “victimless” crimes, i.e., traffic violations, prostitution, and other misdemeanors.

1.3 Microeconomics

This segment of economics deals with individuals and businesses. The primary effect is the direct loss of money or property by the victim. In most cases, the dollar amount of money or property can be determined after the commission of the crime. In other cases, this may not be true. There are a few crimes where the reputation of the victim is damaged. The victim usually suffers a loss. Any person or business can become a victim. The cost to the victim can be enormous, or there can be no economic loss. The costs to the local

community and the nation can be enormous when considering the total costs. The following examples of crimes show how victims can suffer a loss.

1.3.1 Arson

This crime can affect both the victim and the insurance company. If the victim has no casualty insurance coverage, then the business or individual will undoubtedly be put out of business or home if the owners do not have the capital to rebuild. If the victim has insurance, then the insurance company has to pay the claim. If the casualty is caused by the victim in order to collect insurance, then the insurance company can refuse to pay and the victim will normally suffer the loss. In either case, one or the other, or both, will realize a loss of property or money.

1.3.2 Bankruptcy Fraud

This crime affects the creditors of a business. They ship goods to a customer with the expectations of receiving payment on agreed terms. The customer diverts the goods elsewhere and does not make the payment. The creditor suffers a loss of not only the cost of the merchandise but also the gross profits. For small businesses, this can be devastating. They are usually not able to recover the losses. For larger businesses, they pass the loss, which could take weeks, months, or even years to recover, on to other customers by raising their prices.

1.3.3 Forgery and Uttering

This crime usually involves writing bad checks or cashing stolen checks. The amount of the loss is the amount of the check(s) involved. This crime also involves the criminal submitting false or forged documents to obtain a financial gain.

1.3.4 Larceny

Larceny is also called theft. It involves the criminal taking of property from a victim. The value of the property is the economic loss incurred by the victim.

1.3.5 Identity Theft

This crime involves using the identity of the victim to obtain financial gain. The criminal uses the victim's Social Security number or driver's license number to obtain credit. The criminal uses credit to obtain goods and services. The goods and services are not paid by the criminal. The creditors try to get the victim to pay the bills. Even though the victim does not have to pay the bills, it ruins the credit standing of the victim. In this case, the creditors suffer the economic loss.

1.3.6 Loan Sharking

The borrower pays interest at a very high rate. Usually, the interest is so high that the borrower can never get the principal reduced. As a result, the loan shark may use violence against the borrower, which in turn results in the borrower getting further behind on his payments because of additional bills, e.g., medical expenses. In the case of organized crime, the borrower may be forced to commit some other act, usually economic, which will either repay the lender or help the lender to get some economic advantage.

1.3.7 Credit Card Fraud

Most stolen credit cards are stolen before they reach the intended customer, although many credit card numbers are stolen by store cashiers or other store employees. In some cases, credit cards are counterfeited, sometimes using legitimate numbers. Stolen credit cards are used to purchase merchandise that is fenced to an illegitimate vendor. The vendor in turn sells the merchandise for cash. The cardholder is not liable for the purchases if he reports the theft to the credit card company within 30 days. This requires the cardholder to review his statements every month. After he discovers that his card is stolen, he is still out some money, usually \$50 after the credit card company is notified. One organized crime group ships the goods overseas for resale. Credit card companies report that they lose multiple millions of dollars through credit card fraud. This is the primary reason for them charging high interest rates of 14 to 18%, or even higher in some states.

1.3.8 Mail-Order Operations

This crime occurs when a customer sends money to a mail-order house for the purchase of merchandise and the mail-order house does not send the merchandise, but pockets the money. This is called a “boiler room” operation. Some states have required licensing of telemarketers. This has not prevented or deterred these operations, but it has made it somewhat easier to track down corrupt telemarketers by law enforcement.

1.3.9 Medicare/Medicaid Fraud

This crime involves health professionals obtaining Medicare/Medicaid numbers from patients. The health professionals submit false claims to the government for goods and services not provided to the patient. This is fraud against the government.

1.3.10 Repair Fraud

This crime involves various types of repairmen who either do not fix the item needing repair or charge for services not performed. The victim suffers a loss by the amount charged by the repairman.

1.3.11 Skimming/Embezzlement

Skimming involves the diversion of business receipts from the business, in effect stealing from the business and the government. The owner of the business is usually trying to hide money from either the tax collector or a partner. Embezzlement is the stealing of money from the employer. The economic loss is the amount of funds diverted or stolen.

1.3.12 Stock Manipulation

Stock manipulation is the transfer of stock between related entities or people in order to increase the market value. When the value is high, normally far above the market value, the stock is sold to other investors. Later, the value of the stock or bonds drops to the actual market values. The investor later suffers a loss measured by the cost less the amount realized when sold.

1.3.13 Swindlers

The perpetrators of this crime are often referred to as con men. The word *con* is short for confidence. The criminal gains the confidence of a victim. When the con man has a victim's confidence, then he or she will take money or property from the victim and disappear. The economic loss is determined by the amount of money or property lost by the victim.

1.3.14 Narcotics

The use of narcotics by consumers has devastating effects at both the micro- and macro-economic levels. This section deals with the microeconomic level. First, narcotic use diverts consumers' funds to narcotics, instead of for everyday living expenses. The narcotic user becomes addicted, which drives the user to want to buy more and more. After a time, the narcotic user will use all his resources to purchase the illegal substance. Crack cocaine is one narcotic that will do this in a relatively short time. There is no such thing as a casual drug user. The narcotic user will eventually do anything to get funds to purchase more narcotics. The user's performance on his job drops and absenteeism increases. Eventually, the user will lose his job. In some instances, he will steal from his employer and may get caught. Narcotics users would rather pay for narcotics than for their living expenses. When they lose their jobs, they resort to borrowing and stealing from others.

The street pusher, who sells the narcotics to the consumer, is usually a user himself. If not, the pusher is trying to make money in order to get out of his economically depressed state. Street pushers have been found to be as young as 12 years old. In recent years, criminal organizations like to have kids do their drug pushing because they do not serve time in jails or correctional centers. Also, they have an easy market for drugs because they can sell to elementary, middle, and high school students.

The drug kingpins reap the major profits from drug trafficking. They usually do not use or possess any drugs. They control and direct the shipments and distribution of drugs. A major part of the profits goes to the drug kingpins. This, in effect, causes the wealth of a community to become concentrated from the many to the few. In small communities, this can be readily evident by observing who the wealthy people are in the community and by their occupations or business ventures. In metropolitan areas, this is not so evident because of the intermingling of wealthy people from both legal and illegal business ventures.

1.4 Macroeconomics

Macroeconomics deals with the local community (city or county), regional, national, and international levels. Academia is interested in the economic aspects of crime. Law enforcement is also interested. Large metropolitan police departments monitor crime areas in order to move resources to combat it. Various federal agencies have economic or statistical units. These units keep track of various types of crimes.

1.4.1 Organized Crime

Organized criminal organizations operate at both the micro- and macroeconomic levels. Legally speaking, organized crime is defined as three or more individuals. Actually, they range from a handful to thousands of members. These individuals usually operate as a

group. Their main goal is financial gain. In some organizations, power is another goal. Organized crime provides the biggest threat to local communities and the nation.

The magnitude of organized crime, as measured by its income, continues to be of much debate. James Cook, *Forbes Magazine* (1980), estimated that organized crime is a large and growing part of the national economy. He projected that its income was over \$150 billion annually. Cook based his estimate on gross criminal income by types of activity taken from various original sources. However, as reported by The President's Commission on organized crime, Peter Reuter (1983) believed Cook's estimates were too high by a factor of four. Cook asserted that organized crime was the second largest industry in the U.S. during 1979. The Wharton School of Economics conducted an independent study of the income of organized crime using new data sources on the number of persons engaged in organized criminal activities and on the average income of people involved with criminal organizations. The data were collected from law enforcement agencies and from a sample of 100 IRS tax cases involving members of criminal organizations. Wharton estimated that gross receipts ranged from a high of \$106.2 billion to a low of \$65.7 billion. It also estimated that net income ranged from a high of \$75.3 billion to a low of \$46.6 billion. Wharton indicates that organized crime is a major industry. Wharton's income estimate of \$47 billion in 1986 equals 1.13% of the U.S. gross national product. It estimated that organized crime employs at least 281,487 people as members and associates, with the projected number of crime-related jobs over 520,000.

Manufacturing and mining operations are the only major industries that do not appear to be heavily infiltrated. A major concern with organized crime involvement in legitimate industries is that threats and intimidation may be used to limit competition and obtain excessive profits. The measurable result of such activities is higher prices. Taxes are not paid on much of the income generated by organized crime; implicitly, this results in higher taxes being imposed on the incomes of other citizens to make up for this loss in tax revenues. Based on the lower-level estimate of organized crime income (\$29.5 billion) and the assumption that taxes are not paid on 60% of this criminal income, it is estimated that personal taxes on other citizens were \$6.5 billion higher than would be the case if all organized crime income were taxed.

Most studies often used in organized crime do not actually relate to organized crime. Most of the income estimates are for all types of criminal activity and include much more than organized crime. The other common characteristic of most studies is a focus on illegal activities, especially drugs and gambling. Less attention is paid to the other side of organized crime: its involvement in legitimate businesses and labor unions. As a result, part of the income of organized crime is not counted and part of its impact on society, through its infiltration of the legitimate economy, is missed. It is known that organized crime involvement in the legitimate economy is increasing. Previous studies were used and updated. In some cases, new data were obtained and used for the 1986 report to the President's Commission on Organized Crime.

1.4.1.1 Local Industries

In the local community, organized crime operates many businesses, legal and illegal. Organized crime likes to operate illegal activities in communities as follows:

- Prostitution
- Gambling
- Narcotics trafficking

- Trafficking in stolen goods
- Auto theft and repairs
- Extortion
- Illegal liquor making or distribution
- Trafficking in tobacco

Local businesses that organized crime likes to operate in the legal arena are:

- Construction
- Waste removal
- Garment industry
- Food processing, distribution, and retailing
- Hotels
- Bars
- Banking
- Business and personal services
- Legalized gambling
- Liquor retailing and wholesaling
- Entertainment
- Motor vehicle sales and repairs
- Real estate
- Other cash-oriented businesses

It likes to operate these businesses for three reasons. First, it can launder its illegal profits through a legitimate business. Second, it can skim profits by various methods. Last, if organized crime can obtain a monopoly in the area, then it can get higher prices for its products and services. This results in greater profits.

1.4.1.1.1 Construction. Organized crime likes the construction industry, particularly in major metropolitan areas, because it can get profits through “ghost” (nonexistent) employees, extortion, and control of materials. For contractors to get jobs, they must employ ghost employees, pay kickbacks, and pay higher prices for raw materials. All of these costs are passed down to the consumer in the form of higher prices for goods and services, higher rents, higher taxes, and other costs.

1.4.1.1.2 Waste Removal. Organized crime affects the waste removal industry by controlling either labor or the dumping sites. Labor unions are a favorite target for organized crime since it can gain from exploiting labor. The labor is mostly uneducated, and therefore an easy target. Either dumping sites are owned by criminal organizations that charge excessive charges or wastes are simply dumped at unsuspecting sites without the permission or knowledge of the property owners.

1.4.1.1.3 Motor Vehicle Sales and Repairs. Organized crime deals a lot in motor vehicles in several ways. First, it steals vehicles and transports them to other states where they are sold to unsuspecting customers. Second, it likes to use repair shops to sell parts from stolen cars that were previously obtained from “chop” shops. These parts are sold at new-part prices.