

## Money Laundering Mitigation and Capital Formation in Nigeria: Relevance of Know Your Customer Instrument

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### Abstract

*The study investigated the efficacy of the money laundering mitigation instrument of Know Your Customer (KYC) on capital formation in Nigeria. The study deployed the Financial Action Task Force (G7 government) and the Nigerian Anti-Money Laundering Prohibition Act (2011) to benchmark the espoused nexus between the variables. The study is hinged on forensic investigation theory. The study adopted the ex-post facto research design and used quarterly data from '1Q' 2010 to '4Q' 2019, which was sourced from the Nigeria Inter-Bank Settlement Scheme (NIBSS), National Bureau of Statistics, and CBN statistical reports. From using the Correction Model (ECM) to analyze the data, it was observed that the KYC policy instrument has a negative non-significant effect on capital formation in Nigeria. Following this, the government must address the twin issues of proper mapping and delineation of all streets (in both urban and rural areas) towards creating a national directory (database), as well as creating a reliable national citizen database to facilitate KYC. Regulatory authorities must enforce sanctions against erring banks, and bank managements must divorce career growth from the number of new customers attracted and the volume of deposits mobilized.*

**Keywords: Know Your Customer Policy, Capital Formation, Forensic Investigation Theory, Money Laundering.**

### 1. Introduction

The unbridled quest for money has continued to hunt the human race. The impressive developmental strides in the human race appear to have given traction to the insatiable drive for wealth by the majority within society, thus leading to unwholesome acts, which undermine the common good. The situation is exacerbated further by the monopolistic legal status assigned to money globally, as the only means of acquisition of both the basic necessities and extra flavours of life, which impels the sustained quest for money for all and the higher impetus among some, without ethical boundaries. Following this, various unlawful activities, often of a criminal nature, including the massive theft of public resources, are undertaken to acquire wealth. Also, massive inflows of raw cash accrue from such underworld activities and official sleazes, way beyond the immediate expenditure needs of the undertakers. Hence, the need to legitimize the dirty cash inflows via the formal financial system (Opudu & Ogoun, 2023). This act, generally or legally described as money laundering, has continued to be a societal menace.

The resultant and cascading effects of the acts of money laundering are pervasive. In contributing to the conversation on proceeds of crime from a public sector prism, Wrage, (2007) observed that "bribery at all levels, from supposedly 'petty' extortion to its grandest forms, is a tentacled crime whose damaging reach, is pervasive and nearly incalculable. It is a grave and intrusive kind of criminal activity that reaches into every arm of government, taints every aspect of business, and ultimately unbalances the entire system of government and commerce. Further contextualizing the magnitude of the menace, Wrage, (2007) opined that "a leader not held to account is prone to sets no limits on his greed and can plunder a society from above, by extracting bribes with such rapacity that the country is crippled and stunted in its development." Such criminal proceeds need to be legitimized via injection into the formal system, which spurs laundering activities. In buttressing this, the works of: Opudu & Ogoun, 2022; Nestor et al., 2016 and Vandana, 2012 further illustrated the effect of laundering money on the victim nation.

To combat this menace, the Financial Action Task Force (FATF) recommends knowing your customer (KYC) as one of the core policy measures for member nations to adopt (FATF, 2016). Hence, the policy was also adopted and enshrined in the "Nigerian Money Laundering (Prohibition) Act, 2011" to ensure that banks and other financial gatekeepers mandatorily gather intelligence on their customer's transactions and disclose such, where necessary to the Nigeria Financial Intelligence Unit (NFIU). The perception of this policy is hinged on the fact that the role of containing money laundering begins with the ability of banks and non-banking financial institutions to know their customer's businesses, which in turn could serve as a strong internal control mechanism (Aleksandre, 2018; Arasa & Ottichilo 2015). However, KYC policy as an instrument to counter money laundering has been described by Arasa & Ottichilo, (2015), and Ehi, (2015) as the first line of defense for financial institutions against financial crimes. Whereas capital formation is the accumulation of net assets throughout an accounting period for a particular nation; or the aggregate of asset stock values; which shows the level of additional value creation in the nation's economy that is invested rather than being consumed. Capital formation is imperative for bolstering economic activities in an individual right's proprietary economy.

Accordingly, leakages via illicit crime proceed, not only forecloses the efficiency of money laundering policy instruments but also limit the availability of investment funds in the formal system (Opudu & Ogoun 2023). That is why Pathania, (2013), and Ajose and Oyedokun, (2018) stated that the technical progress of a nation's production potential that can balance the growth of different sectors of the economy is dependent on the adequacy of capital formation. Also, the extant literature (Norton, 2018; Ehi, 2015; Lehman & Okcabol, 2005) has documented the consensus that money laundering constitutes a massive leakage to a nation's financial system, with severe implications for a nation's economy, ranging from distorting the markets to undermining security to jeopardizing the economy. Therefore, money laundering containment efforts have gained global traction, with some formal organized legal structures for combating the virus. The a priori assumption of the study is that blocking financial leakages from an economy should lead ordinarily to accumulating funds for capital. Therefore, this study interrogates the effect of KYC policy as an instrument for combating money laundering on capital formation in Nigeria.

## **2. Literature Review**

### **2.1 Conceptual Clarifications**

The revised Anti-money Laundering Act of Nigeria 2011, defined money laundering as "when a person in or outside Nigeria directly or indirectly conceals or disguises the origin or; converts or transfers, removes from the jurisdiction, acquires, users, retains or takes

possession or control of; any fund or property, knowingly or which he/she should reasonably have known that such fund or property is, or forms part of the proceeds of an unlawful act". The International Monetary Fund (2006), conceptualized the term as "the process by which the illicit origin of assets gotten or generated by unlawful operation is masked to obscure the connection between the funds and the illegitimate source of activity". Launderers' effort at this point is to cover up the origin and nature of the ill-gotten funds and afterward inject it into the economic system in a manner that the law enforcement agencies and tax collecting authorities may believe that its sources are genuine (Opudu & Ogoun, 2022; Aleksandre, 2018; Norton, 2018).

On the other hand, Know Your Customer (KYC) is a policy measure within the Anti-Money Laundering (AML) precinct that requires financial institutions under the Anti-Money Laundering Act, 2011 and CBN prudential guidelines to properly capture and document beyond the behavioural and physiological identity of customers, during the process of accounts opening relationship. Such customer information must be detailed enough to facilitate effective surveillance of any suspicious transactions to report to NFIU. Therefore, monetary institutions are saddled with the obligation to ensure that the precepts of the Act are religiously adhered to, and the expected KYC policy framework of "customer acceptance policy, customer identification procedures, monitoring of transactions and risk management are incorporated in the process" and business dealings (Ehi, 2015; Ogunlowore & Oladele, 2014). The justification is that the effective containment of financial crimes cannot be achieved without the involvement of monetary institutions and other relevant agencies like auditors and accountants etc. (Hasset, 2013). The Central Bank of Nigeria (CBN) considers KYC as a key factor policy that serves as a medium of curtailing illegal banking transactions and such that can improve and aid national financial intelligence gathering (Effiom, Achu & Edet, 2019; Ogunlowore & Oladele, 2014). In essence, KYC simply implies knowing the true identity of your customers and their financial dealings.

Okoro (2014) revealed that financial institutions are often monitored and advised to follow the right policy frameworks of KYC policy and anti-money laundering measures. The KYC policy guidelines are crucial AML measures that are expected to aid and safeguard the financial sector against those who want to use it as a channel for financial crimes or layer their illicit wealth (Adewoye, 2013; Iganiga, 2010; Quessada, 2010). Regulatory institutions and other players have shown themselves to be traffic wardens or gatekeepers, with a legal obligation to help in controlling and monitoring the flow of 'financial traffic' and money laundering. As a result, financial institutions are engaged in national security mechanisms to the extent that they must not only pursue their core objectives but also be required to sort monetary mobility, compare, surveil transactions, and identify clients (Opudu & Ogoun, 2023; Salter, 2007).

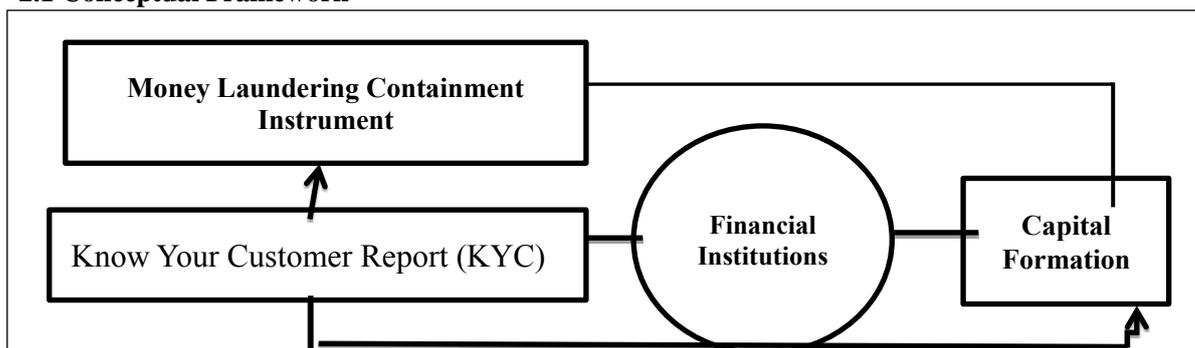
### **2.1.2 Gross Fixed Capital Formation**

Gross fixed capital formation (GFCF) is a macro-economic expression that is mainly used in reporting national accounts which measures the values of current and (new)non-current asset acquisitions by the government, private sector, and the whole of households (minus their unincorporated companies) less fixed asset disposals (Opudu & Ogoun, 2022). It is that part of "real gross domestic products (RGDP) expenditure that indicates how much a nation's new value-creation is added as an investment in the economy that is not consumed" (Amahalu et al, 2016). It can also be seen as the method of gathering or accumulating considerable investable resources that may give rise to more wealth, or the growth of additional wealth (Arowosaiye, 2015; Ugwuegbe & Uruakpa, 2013).

Notably, there is a paradoxical relationship between money laundering and capital formation which depends on whether a country is at the carting or receiving end. Countries

that have received or sheltered laundered cash can make extensive use of and reuse these funds for the growth of their economies since they add to the kind and volume of the accumulated assets employed in the nation's productive activities. In contrast, the victim nation where the laundered monies are illegally coming from may have lost a significant portion of her capital assets that were meant to be part of her collected financial assets for the improvement of such country's economic productive operations. Such movement of funds turns into capital flight, which hurts and lowers the capital creation of the affected country.

## 2.1 Conceptual Framework



**Figure 1: Conceptual Framework**

*Source: Researchers' Conceptualization of the Study (2022).*

The conceptualization in Figure 1, describes three major constructs which include the predictor factor, criterion factor and mediating factor. Hence, the primary predictor variable is the Know Your Customer Report (KYC) as a proxy for the Money laundering containment instrument and the criterion variable is the Fixed Capital Formation of the nation; while the financial institutions are the mediating factor or variable. The dimension (proxy) of the predictor variable (money laundering containment) was adapted or coined from the work of Reganati and Oliva (2017) which basic explanatory variables were: money laundering rate, gambling and gaming, education, information technology penetration, GDP growth, shadow economy, money laundering conviction rate, corruption rate and Incidence of the mafia. On the other hand, the measure of the criterion variable is the gross fixed capital formation of the nation. Financial institutions constitute a mediating factor between money laundering containment and capital formation. This is based on the fact that the process of money laundering which is described as "the placement stage, layering stage and integration stage" can only suffice if financial institutions play the mediation role (Sharman 2011). That is why FATF (2016) and AMLA (2011) advocate measures that can safeguard the financial system from being exploited or utilized as a channel for financial crime activities through the above-mentioned parameters. Hence, Arasa and Ottichilo (2015) describe KYC, BVN and CDD as the first line of defense for a financial institution against criminals.

## 2.2 Gap in Literature

In the early 20th century, Edmund Locard pioneered "forensic science in France; he formulated the theory which states that every contact leaves a trace". This assumption is described as "Locard's Exchange Principle," and it serves as the foundation for all forensic disciplines as known in modern times. The principle of trace evidence can be used to link

individuals or objects, and it is frequently used as a leading or jumping-off point for a specific line of inquiry. The trace (proof) evidence aids in putting together the missing pieces of the investigative enigma to determine where the criminal (offender) is coming from, as well as enables an audit trail and removes the veil (mask) behind a corporation where the true owners of an entity can properly be identified, including their source of funds.

Baird and Zelin (2009) assert that the theory is an important investigative tool for the detection of fraud, financial crimes and more especially money laundering matters. The Forensic investigative theory is the integration of accounting, auditing and investigative skills to provide useful information for decision-making (Ozili, 2020; Humphrey, & Owen, 2000). It is the detection and investigation of financial crimes using criminal methodologies and accounting skills in an investigation that can aid the legal process and support trial evidence. (Ozili, 2020; Huber, 2017). It is also known as using an expert with financial investigative abilities to conduct an inquiry, in such a way that the results may be used in a law court. The works of Dhar and Sarkar (2010) entail a thorough analysis of evidence in support of a claim in order to evaluate if the stated criteria reflect the genuine image and facts that the court requires. More specifically, this nature of inquiry is utilized in investigating corporate crimes, theft, embezzlement, money laundering, tax evasion, asset hunts, fraud, public corruption and many other sorts of unlawful conduct (Huber, 2017; Ozili, 2020).

There are handful of empirical literature on the money laundering concept and its relationship with terrorism, and economic growth, but not much has been done on the nexus of "money laundering and gross capital formation". Based on the foregoing, the works of Qi and Ongena (2018) interrogated whether bribery and corruption can affect firms' access to credit facilities in the banking sector. The work employed regression technique on a sample size of 12006 firms across 22 developing nations. Their findings revealed that bribery and corruption amount to a major challenge to firm development and productivity, as such banks offer less credit access to firms associated with bribery and corruption. This adverse effect is more evident when there are fewer foreign banks nearby or when there is either little or extremely intense competition in the local banking sector.

Opudu and Ogoun (2023) examined the anti-money laundering containment instrument of suspicious activity reports (SARs) and how it affects capital formation in Nigeria. The study anchored on financial surveillance theory and adopted Ex-post facto research design. The collected data span from 2010 to 2019 and were analyzed using an error correction technique. The findings revealed that STR has a positive substantial effect on capital formation in Nigeria. Mekpor (2018) examined the factors influencing the FATF members' compliance with anti-money laundering regulations. The study used the AML and CFT compliance index from 2004 to 2016 and analyzed the data with the ordinary least square technique. The findings revealed that AML/CFT compliance levels are positive for the selected countries.

Alberto (2016) looked at bank ownership records and anti-money laundering measures in Spain. He evaluated the efficacy of Spain's new financial ownership law to Germany and France in combating economic crimes and terrorism financing. The research pointed out that the act has defects in terms of the process of digitalizing individual private data, as well as a lack of data security, as a consequence of which third parties have unrestricted access to personal information. Idowu and Obasan (2012) looked at anti-money laundering and banking sector performance, focusing on three selected banks in Lagos State in the Western part of Nigeria. The data were gathered using a questionnaire approach and were evaluated with descriptive and correlation research design. The study discovered a strong and positive significant correlation between AML policies and bank performance with

a coefficient of determination of 77.5 percent. This implies that banks in Nigeria can perform reasonably without illicit monies in the industry. Hence:

*Ho: The AML policy of Know Your Customers (KYC) has no substantial effect on capital formation in Nigeria*

### 3. Data and Methods

The ex-post facto research design was employed in conducting the study. In addition, the study included yearly time series data that were transformed into quarterly data using E-view. The purpose is for the data to cover a wide range for the analysis because the study only takes cognizance of the 2011 AML Act as amended. These data were derived from the National Bureau of Statistics, Nigeria Inter-Bank Settlement Scheme (NIBSS) and Central Bank of Nigeria yearly Report 2019. Regression approach and descriptive statistics were employed (Gujuratti & Sangeetha, 2008). The error correction model (ECM) of analysis was used to evaluate the hypothesis because of the estimation usefulness of short and long-term effects of the time series on each other. In order to analyze the data, the coefficient of determination, t-test, and f-test were used.

#### 3.1 Specifications of the Econometric Model

Regression analysis, which is a statistical approach for identifying correlations between variables to forecast future values, is used to examine the data. Using the equation:

$$FCF_{it} = F(KYC_{it}, U_{it}) \dots \dots \dots (1)$$

This can be written in explicit form as:

$$L(FCF_{it}) = \beta_0 + \beta_1 KYC_{it} + \mu_{it}$$

**Where:**

- $FCF$  = Fixed Capital Formation
- $KYC$  = Know Your Customer Report
- $\beta$  = Coefficient of parameter
- $it$  = Time coefficient
- $\mu$  = Error term

#### *A priori* Estimate Expectation

This study's primary model is  $FCF_{it} = \beta_0 + \beta_1 KYC_{it} + \mu_{it}$ . Thus, its objective was to assess how Nigeria's capital formation was be affected by a policy instrument against money laundering. As a result, a positive significant link between the predicting variable and the criteria variable is anticipated. The study's underlying presumption is that stopping financial leakages from an economy should typically result in capital fund buildup.

### 4. Data Analysis and Discussion of Findings

#### 4.1 Descriptive Statistics

The results of the descriptive statistics, shown in table 1 below, include the mean, median, maximum, minimum, standard deviation, kurtosis, Jarque-Bera, and probability for the data. The connection in the data series used for the investigation is depicted in Table 1. The logs of fixed capital formation (FCF) and know-your-customer (KYC) measurements are regressed as a result. The null hypothesis of normality is used in the normality test in contrast to the alternative hypothesis of non-normality. As a result, the regression's null hypothesis is accepted since, at the 5% level of significance, the probability value is lower than Jacque Bera's Chi-square. As a result, the aforementioned finding suggests that the variable hypotheses are normally distributed since the probability values are below the Jarque-Bera chi-square distribution. So, at the 0.05 level, they pass the significance test.

**Table 1: Summary of Descriptive Statistics**

	<b>LOG(FCF)</b>	<b>LOG(KYC)</b>
Mean	8.206473	4.102029
Median	8.143004	4.100989
Maximum	9.244978	4.297285
Minimum	7.610541	3.433987
Std. Dev.	0.427058	0.161610
Skewness	0.967755	-2.274504
Kurtosis	3.111677	9.906976
Jarque-Bera	6.264450	113.9996
Probability	0.043621	0.000000
Sum	328.2589	164.0812
Sum Sq. Dev.	7.112764	1.018597
<b>Observations</b>	<b>40</b>	<b>40</b>

*Source: Authors' Computation (2023)*

#### 4.2 Stationarity Test via Unit Root

The stationarity of the time series data for the chosen variables was examined using Augmented Dickey-Fuller (ADF) tests. The stationarity test results are listed in Table 2. The variables in Table 2 do not pass the Augmented Dickey-Fuller (ADF) unit root test in the first instance because they are not stationary at the level. The unit root test of the chosen variables, however, shows that each variable is stationary at the first difference in the I(1) series. All of the variables must be differentiated before estimating since they are not stationary at all levels. As a result, differencing the variables eliminates whatever long-term information they may have carried. This is a process that could enable us to carry out the estimation equation model.

**Table 2: Unit root test result using ADF procedure for the model**

<b>Variables</b>	<b>Augmented Dickey Fuller Test</b>				<b>d(I)</b>	<b>Remark</b>
	<b>@level</b>	<b>@ 1<sup>st</sup> Diff</b>	<b>Lag</b>	<b>5% C. L.</b>		
<b>Log(FCF)</b>	-0.215054	-11.51896	2	-3.533083	I (1)	Stationary
<b>Log(KYC)</b>	-4.062695	-3.977971	2	-3.533083	I (1)	Stationary

*Source: Authors' Computation (2023)*

#### 4.3 Money Laundering Mitigation and Capital Formation

Table 3 illustrates the considerable relationship between Nigeria's capital development and its KYC policy. The error correction term reveals how quickly our model recovers to equilibrium after experiencing short-run variations. According to the adjusted R2 value of 0.2299, the predictive variables may account for 23% of the systematically occurring fluctuations in the criterion variable (FCF). Therefore, the "adjusted R square" represents the explanatory power of 23%. This indicates that the provided model has a satisfactory level of fit. This number can be regarded as adequate since, in addition to knowing your customer (KYC) policy; other variables also affect the criteria variable. Additionally, at a 5% level of significance, the F-statistics value from the table is 3.687854. The F-statistic shows that the model has been correctly described. The money laundering containment measures based on KYC therefore have a negative non-substantial effect on FCF at a 5% level based on the coefficients of the explanatory variables (Coeff= -0.48, t= -0.59, p=0.55). A general guideline for measuring autocorrelation is that the Durbin-Watson statistic (1.910078>0.315517) is higher than R2. This suggests that there is no first-order

autocorrelation.

The calculated model is statistically non-significant at the 5% level, as evidenced by the t-probabilities, which the t-statistics further support. This suggests that the predictive variable, KYC, has a non-substantial negative relationship with the criterion variable. We thus reject the alternative and accept the null hypothesis Ho2, concluding that there is no meaningful association between capital formation in Nigeria and the KYC anti-money laundering policy tool. Another problem area is the bank officials (marketers) whose target actions and interest is to open an account than follow the KYC policy. Hence, they fill and sign the KYC form without necessarily taking the pains to verify the customers' address, nature of business and real ID, to meet market targets for career advancement purposes. Hence, most identity cards are mere documentation processes that cannot be used or give an audit trail for laundering investigations in any eventuality. This data capturing and maintenance is a major problem in developing economies that requires urgent attention. This outcome aligns with earlier observations in related prior studies by (Ehi, 2015; Okoro, 2014; Ogunlowore & Oladele 2014).

**Table 3. Error Correction Model Result and Discussion of Findings**

Variable:	Dependent Variable: DLOG(FCF)		
	Method: Least Squares		
	Coefficient	(t-statistics)	P-Value
Constant	0.063692	3.047447	0.0046
DLOG(FCF(-1))	-0.5886678	-3.769440	0.0007
DLOG(KYC)	-0.487908	-0.596484	0.5550
DLOG(KYC(-2))	0.339420	0.653008	0.5184
ECM(-1)	0.099650	1.328898	0.1933
R <sup>2</sup>	0.3155		
Adjusted R <sup>2</sup>	0.230		
F- test	3.6877		
P-value	0.0140		
Durbin-Watson Stat.	1.91		

*Source: Authors' Computation (2023)*

## 5. Conclusion and Recommendations

The study investigated the effects of the money laundering containment instrument of Know Your Customer (KYC) on capital formation in Nigeria. From the results of the tests conducted it was observed that the policy instrument of KYC has a negative non-substantial relationship with gross capital formation (GFCF) in Nigeria. For that reason, the KYC policy has not yielded the intended result on capital formation in the Nigerian economy, via foreclosing money laundering. This implies that the policy of KYC used by financial institutions as a money laundering containment tool does have a significant effect on halting money laundering activities. The foregoing scenario may not be unconnected with the marked absence of a real database on the populace. The absence of a country-wide reliable citizen database will hamper people's identification. Also, official birth records are scarcely kept, with implications for reliable national citizens' databases. Further, the vast undeveloped rural areas with no street or address systems further exacerbate the scenario. How then can banks verify the data of all their clients? The prevalence of poor address systems, caused by underprivileged infrastructural development and city mapping/planning; weak identity control systems/poor identification data banks give room for the high rate of

unverifiable addresses. Following this, the government must address the twin issues of proper mapping and delineation of all streets (in both urban and rural areas) towards creating a national directory (database). Regulatory authorities must enforce sanctions against erring banks and bank managements must divorce career growth from the number of new customers attracted and the volume of deposits mobilized. Until these are done, the KYC instrument's effectiveness cannot be harnessed for mitigating money laundering in Nigeria.

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