

Even Recession-Proof Cos. Need Strong Compliance Controls

By **Daniel Castleman, Samantha Salkin and Emily Butler**

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According to an Association of Certified Fraud Examiners 2009 study, historical crime analysis indicates an overall increase in occupational fraud during an economic recession.[1]

This ACFE study also shows that, in a stalling economy, payments for child support, mortgages and tuition remain the same, and pressure to maintain prerecession lifestyles increases.[2]

In January, The Wall Street Journal reported that economists polled by the publication put the probability of a recession in the next 12 months at 61%, down only 2% from a similar poll in October 2022.

This makes the topic of compliance controls during an economic recession especially relevant.[3]

The opportunity to commit fraud also grows through a reduction of resources, both in terms of funding and staffing, while proactive measures are often overlooked due to more immediate business concerns.

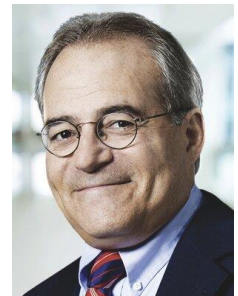
Internal controls, such as multiple approval checkpoints created to prevent and detect fraud, suffer. And recession-related layoffs can also inadvertently expose companies to fraud if compliance positions are eliminated.

Nevertheless, lax compliance programs can lead to considerable reputational, financial and criminal risks. Scandals involving financial institutions, small businesses[4] and major corporations were well-covered[5] through media reports[6] in the months and years following the 2008 recession.[7]

Headlines, at times followed by criminal indictments, settlement agreements, large fines and prison sentences, may also lead to a decrease in profit margins, lower employee-retention rates, and result in potential civil lawsuits from shareholders or customers demanding compensation for mismanagement.

Fraud in Recession-Proof Industries

During an economic downturn, less attention is generally paid to fraud in recession-proof industries



Daniel Castleman



Emily Butler

such as freight and logistics companies, discount retailers and the health care industry.

Companies that expand rapidly following a sharp increase in demand might lack effective systems to prevent or detect fraud, as the focus shifts from compliance to increased revenue targets.

Companies under pressure to meet rising demand might also ignore signs of trouble, allowing fraudsters to evade detection for extended periods of time.

Unlike the recession in 2008, the COVID-19 pandemic brought additional challenges as companies pivoted to remote work models. Burnout, management changes, staff shortages and emerging technology prone to criminal misuse amplified the risk of internal and external fraud.

Almost three years later, these challenges remain.

Freight and Logistics

The ACFE recently published its 2022 report on occupational fraud, which examined 2,110 cases of occupational fraud and found that the transportation and warehousing industry was one of the top three industries with losses caused by occupational fraud, the others being real estate and wholesale trade.[8]

In addition to more commonplace fraud cases involving bribery, price-fixing, kickback schemes and embezzlement, companies in the freight and logistics industries are especially vulnerable to allegations of receiving and/or trafficking in stolen goods because of the complex and often opaque nature of supply chain operations.

For example, organized retail crime involving planned theft of merchandise, passed off as legitimate and sold in huge quantities on online platforms, has been under scrutiny by law enforcement in recent years.[9]

In June 2022, Homeland Security Investigations and the Association of Certified Anti-Money Laundering Specialists published a report finding that "organized theft groups ... launder an estimated \$69 billion in illicit profits through the US financial system and trade-based money laundering (TBML) schemes each year." [10]

Because these businesses are susceptible to fraud, as well as the possible financial and reputational issues that follow, they must be proactive in addressing fraud risks.

Since fraud can occur at any step in the supply chain, the entire chain should be analyzed, including the participation of third-party vendors, distributors and suppliers.

Internal controls need to be examined systematically and continually so that red flags can be identified early.

Monitoring should be ongoing to help identify instances of collusion between parties or changes to the position of partners involved in the process.

Assessment of both internal and external risks should also be conducted regularly.

In the freight and logistics industry, identifying red flags in the supply chain begins with understanding the financial touch points of a transaction. In assessing a compliance program, consider the following questions:

- Are the beneficial owners of these companies tied to other disparate businesses?
- Do companies sending and receiving cargo have the same address, use stock photos on their respective websites and/or list information that cannot be verified?
- Is payment coming from an individual instead of a corporation?

Efforts should be made to identify relationships between business entities and, just as importantly, relationships between key personnel in third-party vendors.

Controls should be put in place to monitor the arrival, clearance and collection of cargo. When applicable, data-driven tools should be utilized to identify the hidden risks described above, identify digital and location intelligence, and flag any changes to third-party vendor information.

Discount Retailers

Discount retailers thrived during the early 1990s recession[11] and the 2008 recession[12] as consumers were willing to spend their limited discretionary income on low-cost items.[13]

One of the major signs of a recession is a slowdown in consumer spending, as people turn away from pricey chains and toward discount retailers.[14]

In August 2022, Business Insider reported that both Dollar Tree Inc. and Dollar General Corp. had higher sales and profits in recent quarters, and an increase in high-income customers.[15]

According to the ACFE 2022 occupational fraud report, the most common fraud scheme in the retail industry was corruption at 43%, including bribery and conflicts of interest; followed by noncash schemes, such as stealing inventory or customer information, at 24%, with its lowest area of risk categorized as financial statement fraud at 4%.[16]

Global searches of news media, journals and trade publications for any references to occupational fraud among discount retailers indicate some of the largest cases involved embezzlement[17] and financial misstatements.[18]

In assessing a compliance program for discount retailers, consider the following questions:

- Does your company implement safeguards such as a separation of duties, threshold authorizations and mandatory vacations?
- Do your company's internal auditors have the authority to review records for all levels at the company, including its executives? Additionally, does your company conduct unannounced audits?
- Does your company maintain effective reporting for employees that suspect internal fraud, such as a confidential hotline reportable to an independent third-party?

As mentioned above, the idea that discount retailers continue to thrive during a recession can actually work to their detriment if approval processes weaken, overall morale decreases and personal motives for committing fraud increase.

Controls should be put in place to monitor high-risk revenue accounts, such as rebates and discounts, as well as invoice and inventory anomalies.

Health Care

Similar to discount retailers and the freight and logistics industry, the health care sector has long been described as recession-proof.

In October 2021, the University of Illinois Chicago's School of Public Health published a study exploring the relationship between local economic conditions and health care employment, concluding that "when counties experience more severe economic downturns, healthcare employment seems to increase." [19]

The health care industry is also susceptible to fraud, often committed by medical providers, patients, and third-party suppliers and providers.

The National Health Care Anti-Fraud Association estimates that health care fraud costs about 3% of the country's total health care expenditures each year. Given that total health care spending in 2021 was \$4.3 trillion, this would mean \$129 billion in health care fraud. [20]

The most common types of health care fraud include false billing schemes, kickbacks and medical identity theft.

The COVID-19 pandemic changed the health care landscape, with a shift from in-person services to telemedicine and an increased need for durable medical and personal protective equipment. These changes are reflected in the proliferation of new types of health care fraud.

The COVID-19 pandemic also saw the advent of new targets for fraudsters as federally funded pandemic assistance programs were put into place.

The National Health Care Anti-Fraud Association has also warned against more direct-to-consumer types of pandemic-related fraud, including phishing scams and door-to-door COVID-19 testing offers. [21]

In assessing a compliance program for the health care industry, consider the following questions:

- Does your company look for process anomalies, such as payments made on weekends, local holidays or outside of regular business hours?
- Does your company utilize data-driven tools to identify hidden fraud such as flagging medical test or equipment orders for patients that have not been seen for a period of time?
- Does your company conduct due diligence on its third-party providers, including vendors and contractors offering telehealth services, to ensure these providers do not have undisclosed conflicts of interest, a history of prior personal or professional misconduct, and/or financial difficulties, which may be a motive to commit fraud?

Conclusion

A compliance assessment could look vastly different from one company to the next, depending on the industry, the size of a company, whether it operates in a high-risk industry or jurisdiction, and the volume of dealings, among other factors.

Each company should incorporate its own risk-based approach to detect and mitigate fraud and other financial crimes.

Companies should develop a fraud detection capability to avoid the expense of being a fraud victim or running afoul of regulators.

And it may not just be a question of volume, but also a question of duration. A systemic failure to identify fraud can extend the duration of the fraud, and the related losses.

Daniel J. Castleman is a vice president, Samantha Salkin is a principal and Emily Butler is a consulting associate in the risk, investigations and analytics practice at Charles River Associates.

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