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# Practitioner Insights: Environmental Fraud—New or Not?

''Fraud'' is a term typically associated with Bernie Madoff, Ponzi schemes, and other situations where perpetrators have achieved financial gain. But fraud in the environmental area hasn't captured recent headlines until Volkswagen was found to have installed emissions cheating software in their diesel models, a decision that has cost VW more than $20 billion to date. One positive aspect of the VW scandal may be raised awareness of environmental fraud, and for environmental professionals and their stakeholders to take action. This article examines fraud concepts, how environmental fraud can occur, and steps to reduce the likelihood and impact of environmental fraud.

***Concepts*** Fraud is any intentional misrepresentation or deceit (by commission or omission) with the intent of achieving unfair or unlawful gain at the expense of another party. In 1973, sociologist-criminologist Donald Cressey published a hypothesis about what drives people to violate trust and commit fraud. His hypothesis was three elements must be presented for fraud to occur: pressure (or incentive), rationalization, and opportunity. The ''Cressey Fraud Triangle'' has become the standard for considering and analyzing fraud.

Whether an act or omission, in fact, is fraud is determined by the judicial or other adjudicative system. Fraudulent activities pose risks to an organization's financial position, operations, compliance, or reputation.

**Pressure** The pressure or motivation often is financial. People may be motivated to display signs of wealth, such as expensive cars or extravagant vacations. Other financial drivers may be less visible, such as a gambling addiction or medical bills. Money is certainly involved in environmental management. Transporters who accepted hazardous waste (and payment), accumulated or dumped it, and produced paperwork indicating proper disposal committed fraud. Financially motivated fraud was the driver for many of the environmental legacies we are still cleaning up today.

The pressure doesn't have to be financial. An individual could feel peer pressure to obtain a promotion or professional accolades. The pressure may not even be personal. A manager at a marginally profitable facility could feel pressure to divert waste from proper (and expensive) disposal facilities, or shut off pollution-control equipment to reduce costs and keep staff employed. An individual could falsify records to avoid attention from regulators or to pass an audit.

**Rationalization** Rationalization is the justification for the fraudulent activity. ''Everybody does it'' or ''I don't get paid what I deserve'' or ''it's not that big of a deal' are common rationalizations.

**Opportunity** The third element necessary for environmental fraud to occur requires the most experience in environmental compliance, operations, and reporting: opportunity. Environmental requirements extend to far-flung aspects of an organization, and the opportunity for fraudulent activities extends just as far.

Preventive controls can reduce the likelihood of fraudulent activities. Preventive controls include documented policies and procedures, segregation of duties (tasks and approvals are done by different people), protection of assets, avoiding related-party transactions, and appropriate oversight.

Detective controls can help identify activities that could suggest that fraud is occurring. Detective controls include audits and data analytics. Compliance, contracts, and external reporting are among the areas that pose opportunities for fraudulent activities. Scenarios and examples of controls for each are presented below.

**Compliance** Environmental regulations include operational requirements, restrictions on what materials can be purchased and used, how those materials are stored and disposed of, and requirements to conduct inspections, maintain documents and records, and submit routine and non-routine reports.

There can be pressure to ignore or override compliance requirements to increase production, reduce costs, or preserve jobs. Rationalization can include those noted above, or a belief in regulatory overreach. Preventive controls include written procedures, process controls and instrumentation, and standardized reports.

There are still many opportunities to generate misleading or false environmental information. For example, operators may take samples of wastewater only when they know production is slow and the results will meet permit limits. An employee could adjust the time of an incident on a form or electronic log so that it appears the company reported it to authorities within the prescribed time. Supervisors can have employees sign log sheets for training—and not provide the training, to avoid the cost of overtime or curtailing production.

Environmental audits can be a detective control to identify the possibility of fraudulent activities. Consider a scenario where facility employees tell an environmental auditor that they inspect emergency response equip-

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ment weekly. An employee provides a stack of completed inspection forms, each showing compliance for all equipment. During the site inspection, however, the auditor observes nearly one-third of the equipment to be obstructed, missing, or nonexistent.

Environmental auditors note a gap and specify corrective actions. They typically do not consider the possibility of fraudulent activities. Financial auditors and internal auditors conduct fraud brainstorming in engagement planning, and perform procedures to look for signs of fraud. Auditors are not expected to prove that fraud occurred, but they should recognize signs of fraudulent activities and escalate identified issues.

In the scenario above, did the employees make a simple mistake, or put a positive spin on their program—or is does it suggest fraudulent activities? A fraud risk assessment could envision other scenarios where records also may have been falsified. For each, the fraud risk assessment team would assign an associated likelihood that the scenario occurred and the potential impact if fraudulent activities occurred. It would be reasonable to identify all the compliance records that the ''inspector'' is responsible for, and to examine relevant documents and records.

Additional procedures could examine whether there are false statements regarding environmental compliance on reports submitted to regulatory authorities or to customers for government contract work. Data analytics could be used to review payroll, attendance records, and where the employee used their electronic ID for access to determine if the ''inspector'' was actually present on relevant dates and times. Based on the risk assessment, the audit team could perform additional procedures.

Any effort involving the possible detection of fraudulent activities (such as a well-structured environmental audit) also should anticipate procedures if potential fraudulent activities are encountered. Given the potential enforcement and legal implications, it is essential that counsel be included in these procedures. A good practice is to establish escalation procedures that include criteria for potentially fraudulent activities, notification procedures, and guidelines for what (or whether) additional procedures should be done and by whom.

In the scenario just covered, one approach would be for the environmental auditor to notify the specified parties (including legal), carve out that component of the audit, and proceed with additional procedures only if directed.

**Contracts** Contracts between an organization and suppliers could include environmental provisions. The provisions may be general, such as a requirement to be in compliance with applicable regulations. Provisions may be more specific, such as conformance with an industry code of conduct [including environmental provisions] or implementation of an ISO Environmental Management System.

Contracts impose pressure on both sides to achieve the most successful outcome at the lowest cost or obligation. The pressure for a supplier to achieve sales and avoid additional questions from the prospective customer can be incentives to provide a rosy picture of environmental compliance and performance. If the supplier has to answer only yes or no to one question on a supplier checklist, this also provides a simple opportunity to provide the ''correct answer.'' If the supplier provides false information, they could be subject to local enforcement or exposure by nongovernmental organization. This, in turn, poses risk to customers of disruption in the supply chain or damage to their reputation. The customer can implement preventive controls by more robust pre-engagement due diligence and require the supplier to periodically provide evidence of environmental performance.

The customer can implement detective controls in the form of thoughtful, robust procedures in supplier audits, or independent monitoring of media and industry conferences of suppliers' environmental performance.

**Transactions** Transactions impose pressure on both sides to achieve the greatest possible outcome at the lowest cost. Buyers and sellers could feel obliged to make overly optimistic statements, or omit information that could adversely affect their gain from a transaction. The opportunity for fraudulent activities includes failure to disclose relevant compliance or operational information, or coaching employees to provide information that minimizes risks. The buyer risks completing an acquisition that includes unanticipated constraints in meeting business goals; these can be compounded by fraudulent activities.

There are risks of unanticipated costs to address contingent environmental liabilities. Pre-acquisition due diligence is a preventive control to reduce the likelihood of the Environmental Protection Agency's All Appropriate Inquiry (AAI) Rule has offered a mechanism since 2005 for a standardized baseline to assess a property's environmental conditions and the likelihood of contamination.

The AAI rule does not include risks associated with compliance. A seller may feel pressure to conceal or alter information that indicates noncompliance. Business imperatives may not allow full due diligence, or assessment of environmental risks that could require capital or constrain future operations. In 2008, the EPA published a policy that provides relief from penalties if new owners conduct environmental audits and self-report findings. This provides an incentive to perform an environmental audit, but the EPA policy does not provide relief for achieving compliance. This could involve capital investments—which also could involve curtailing production to install. The buyer faces a related risk if environmental constraints (compliance, availability of resources) prevent changes, or expansion of operations to meet business objectives.

As a preventive control, the buyer can include contractual language that allocates responsibilities for management and costs associated with gaps in environmental compliance. An environmental audit with objec-



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tives aligned with the EPA new owner policy and the buyer's objectives would be good practice. A fraud risk assessment during engagement planning—and testing as part of audit procedures—could identify suspicious data or information that deserves additional attention.

If an environmental audit identifies gaps, additional procedures can evaluate whether the gaps arose from information that was false, misleading, misrepresented, or willfully withheld. If this is the case, the buyer may feel more strongly about pursuing available remedies.

**External Reporting** Regulations have required reporting of compliance-related information for decades. External reporting on environmental matters has expanded dramatically in the past 20 years and shows no signs of slowing down.

The Global Reporting Initiative was founded in 1997 to encourage voluntary reporting of environmental, social, and governance practices and performance. The CDP (formerly Carbon Disclosure Project) encourages voluntary reporting of greenhouse gas emissions, and water use and management. The Sustainability Accounting Standards Board was founded in 2011 with the objective of encouraging more complete disclosures of material ESG issues in the Management Discussion & Analysis section of the Form 10-K, and has developed a framework and guidance to do so using existing SEC law. These are a few of the more prominent frameworks for external reporting of environmental matters.

Generators of this information may feel pressure to ''keep up with the competition'' with their reports, or to achieve bragging rights about their accomplishments. Individuals can rationalize incomplete or false reporting as puffery or marketing spin. Overall, preventive controls over information compiled for voluntary reporting are not well-developed, so there is ample opportunity to provide false or misleading information.

Audits can be a detective control and can incorporate fraud risk assessment and testing procedures that are standard for Internal Audit. One such audit reviewed the support for content in a company's external environmental report. The company stated the goal of reducing waste generation by 20 percent throughout a five-year period; in the third year, the company was exactly on track to achieve its goal. The audit procedures found significant differences in the progress that individual facilities were making towards the goal. The differences did not appear to correlate with logical factors, such as changes in operations or production levels. The controls were weak for defining ''waste,'' calculating amounts, and allocating those amounts to a unique reporting period. Some shipments slipped between the cracks and were not counted; there were no instances of double-counting. This could be regarded as a simple gap. The auditor performed additional procedures and learned that achieving this goal counted for a significant portion of the bonus compensation of facility managers. Weak controls would allow facility managers to meet goals by adjusting the schedule for waste pick-up, including delaying shipments beyond dates required by regulation.

This scenario could be an example of facility managers manipulating the company's system for short-term personal gain. This gain came at the expense of other managers who were playing by the rules. The risk also could extend outside the organization, however. Companies submit reports on waste generation to regulatory authorities. If data on public record does not match data in voluntary reports, this puts the organization at risk of attracting unwanted attention from regulators or environmental analysts or NGOs.

Consequences of fraudulent activities in external reporting can extend far beyond this simple scenario. Stakeholders use the content of environmental reports for decisions with financial and reputational impact, such as investment decisions, approval as a vendor, favorable product placement, and industry awards. External reports are publicly available. With the development of more IT tools and online analytics, it's becoming easier to compare statements and data across different external reporting channels. Investors, analysts, NGOs, or competitors can raise uncomfortable questions—or allegations of fraud.

***SUMMARY*** There are pressures or motivations, justification, and opportunities for individuals to engage in fraudulent activities. The high-profile Volkswagen emissions testing scandal, and its $20 billion price tag, has raised the awareness of environmental fraud. Stakeholders' use of environmental data and information has become more substantial, raising the impact of false or misleading information. The internet and analytical tools have made discrepancies easier to identify. Social media has accelerated and amplified the potential impact of discrepancies, and allegations of fraud.

Companies should improve preventive controls to reduce the likelihood of fraudulent activities. They should add fraud practices (standard in financial and Internal Audit) to environmental audits, to improve detection of possible fraudulent activities, and to reduce the impact of those that occur.

| Area of Potential Environmental Fraud | Potential Consequences | Preventive Control | Detective Control |
|---|---|---|---|
| Compliance | Regulatory enforcement | Robust policies, procedures | Environmental Audit |
| Contracts | Inability to meet goals from transactions | Strong contractual provisions | Environmental Audit |
| External Reporting | Unwanted attention from NGOs | Strong internal controls | Environmental Audit |

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