

Environmental Risk or Fraud?

A Transaction Gone Bad

Fraud is an essential component in any audit or in any compliance or risk management program. The concept of “environmental fraud” is not yet embedded in compliance or auditing programs. Scenarios are an excellent way to develop skill sets that can be used in planning and conducting audits and in designing systems, procedures, or controls.



SCENARIO: A TRANSACTION GONE BAD

Sarah Seller inherited a family business, but was not interested in continuing to own or run it. She sold the business and property to Benny Buyer. Some contamination was possible from legacy operations, so Sarah Seller agreed to reimburse the costs of any clean-up performed within one year. Benny and his business partner David Developer had other plans for the property – an apartment building with subterranean parking.

When removing in-ground trenches and an oil/water separator, Benny and David encountered some visible contamination. Gerry Geologist took four soil samples, which identified the contaminants and confirmed that the concentrations exceeded applicable guidelines. With Benny & David’s authorization, Gerry Geologist hired Ellen Excavator to excavate contaminated soil. Three months later, Benny Buyer

Fraud is any deceit by one party for gain at the expense of another.

Environmental fraud is any fraud that involves the environment. Cressey’s classic fraud triangle says that opportunity, rationalization, and motivation or pressure must be present as drivers for fraud – any kind of fraud.

sent Sarah Seller a bill for \$1 million: 40 truckloads of soil for disposal at a hazardous waste landfill, at \$20,000¹ each, and \$200,000 in consulting, reporting, and permitting fees. Ellen Excavator’s report included data from the initial samples, and confirmation samples from the side walls after removal of 40 truck loads of material. There was no data from any other samples. The total excavation happens to be exactly the dimensions of the underground parking structure for David Developer’s apartment building.

¹ All the cost figures are for illustrative purposes only.



WHAT'S THE ISSUE?

Sarah Seller was certainly surprised with the \$1 million request. Should she pay? If so, based on what? If not, why not? What is the underlying issue? Is this a simple contract dispute? An example of a poorly-written contract? Is it poor performance - if so, by whom (Gerry? Ellen? Everyone?)?

Or could it be something deeper – like fraud. Perhaps it is a classic business/ transactional fraud. Is it fraud involving environmental compliance, operations or risk? Perhaps it is a combination of the two.

VARIATIONS ON A SCENARIO

Suppose Sarah engaged resources who did some more digging (not the excavation kind!) and found additional facts such as those below.

- **Variation 1:** Gerry and Ellen are siblings. As Gerry solicited two bids for the excavation work, they paid \$1,000 to family friend to submit a higher-cost bid. They have agreed to pay this friend a cut of the consulting fees when Sarah pays the invoice.
- **Variation 2:** Gerry Geologist confirmed from lab results that all the contamination was removed after the first 10 truck loads. Benny Buyer ordered Gerry to destroy the lab results, finish the excavation, and only take samples once it was complete.
- **Variation 3:** 30 trucks of clean soil were sent to a hazardous waste landfill, which was not necessary – but which happens to provide a higher profit margin for Ellen Excavator. This landfill has limited capacity, and had to temporarily close shortly thereafter while waiting for a new permit. A local school district racing to complete a demolition/ reconstruction job before the start of the school year was forced to send their hazardous waste out of state at an incremental cost of \$250,000 to those local taxpayers.
- **Variation 4:** Benny, Gerry and Ellen arranged to transport all the soil – contaminated and clean - to create a new softball field in a low-income neighborhood. Gerry and Ellen created paperwork for Benny showing disposal costs of \$400,000 at a non-hazardous landfill. At David's request, Benny altered the paperwork to indicate disposal at a hazardous waste landfill at a cost of \$800,000. Meanwhile, Ellen got donation receipts from a non-profit organization and is taking a deduction on her company's taxes.
- **Variation 5:** Ellen began excavation near the contaminated area on Friday. After Gerry left for the weekend, David Developer came to the job site. He indicated his rush to begin construction, and instructed Ellen to work over the weekend. The excavation was complete when Gerry returned to work Monday morning.





Additional information provides a clearer picture of the situation. The pictures are very different: basic misrepresentation; a more complicated array of issues involving compliance, ethics, deception and attempted fraud; and a simple miscommunication that could ultimately cost someone over half a million dollars. Whatever the resolution between Sarah Seller and Benny Buyer – and other parties – regulatory authorities may be interested in some of the variations.

TIPS FOR RISK MANAGEMENT PROFESSIONALS AND AUDITORS

The IIA's Institute of Professional Practice Framework states that "Internal Auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives²." The variation involving the softball field may have created additional environmental risks and liabilities, and could substantially impact all the entities' reputation – or worse. Sarah's resources could not find much of the information in the variations above if they had limited their focus on financial transactions. Here are some tips to avoid or detect environmental fraud.

- 1) **Recognize the opportunities:** Although environmental matters are heavily regulated (in the U.S.), there are still opportunities for deception and fraud. This can arise via operations, compliance, and/ or financial mechanisms.
- 2) **Improve controls:** Many readers of the scenario and variations above will recognize weak controls. The contract between Sarah Seller and Benny Buyer was poorly written. A background check on the contractors could have helped, as would formal procedures for interim testing and project approvals.
- 3) **Fraud brainstorming:** Internal Audit should include specialists in fraud brainstorming for any audit or investigation involving environmental compliance, risk, or operations. Ideal capabilities include technical and business experience, as well as training and experience in controls, testing, and fraud.
- 4) **Environmental Auditing:** Environmental Auditing programs should incorporate objectives and practices regarding fraud. Environmental auditors should recognize the opportunities, incentives, and rationalization that can exist involving environmental issues. The IIA's resources offer one good starting point.



Whether you find something or not on an Internal Audit or an environmental audit – that's not the point. The point is to recognize the existence and potential impact of environmental fraud, and to apply resources to prevent and detect it. Like any other fraud.

² Institute of Internal Auditors' International Professional Practices Framework (2017), Section 2210.A2.



I am fortunate to have over 15 years of experience in considering, brainstorming, and testing for fraud. I have done this as an environmental specialist in environmental audits (the “second line of defense (2LOD)”, Internal Audits (3LOD), financial audits and external assurance engagements for conflict minerals (“4LOD”). It’s surprising how many ways there are to circumvent systems and controls related to environmental matters, and to perpetuate fraud. Sometimes the environment itself is the victim.

All told, I’ve been helping organizations manage environmental and related matters in operations, compliance, (financial and non-financial) reporting, and reputation for over forty years. As I apply each successive wave of emerging risks to services such as training programs, and Quality Assurance Reviews of environmental auditing programs, I often recall projects from earlier in my career that are also good examples – if we had only known. The scenario and variations are a (simplified) example drawn from experience in “the archives.”

For more useful blogs and thought leadership – or to learn how DHC can add value for your organization, visit the websites listed below.

www.douglashileman.com

www.environmentalfraud.com

www.auditreadinesspro.com

The Institute of Internal Auditors (IIA) provides resources to all members. Suggestions for further reading:

- Engagement Planning: Establishing Objectives and Scope (Practice Guide)
- Engagement Planning: Assessing Fraud Risks

See www.theiia.org