The Enemies Within Your Organization: Occupational Fraud In The Oil, Gas And Energy Sector

By: Ronald J. Daigle, **Dwayne N. McSwain**, and Philip W. Morris

Abstract

A headline like the following is definitely an attention grabber: "IRAN BILLIONAIRE SENTENCED TO DEATH IN OIL FUND FRAUD CASE." This headline is from a March 2016 story about billionaire Babak Zanjani and two other individuals receiving the death penalty in Iran after being found guilty of embezzling $2.7 billion from the state-run National Iranian Oil Co. (Motevalli & Nasseri 2016). Arrested in 2013, an Iranian court determined the three individuals committed this massive fraud while attempting to circumvent international sanctions on Iranian crude exports. All three individuals are obviously appealing both their convictions and sentences. Although the sheer size of this fraud (as well as the severity of the sentence) is eye-catching, the amount of fraud commonly committed by an organization's own employees also should be quite alarming to companies within the oil, gas and energy sector. This fact is demonstrated by survey results gathered by Big 4 firm KPMG about the current climate of business integrity. Of those surveyed who are employed in the "energy & natural resources" industry, 74% stated they had "personally seen" or had "first-hand knowledge of" misconduct within their organizations over the prior 12-month period (KPMG 2013). A clear majority of these same survey respondents also recognized the severity of the misconduct, with 53% noting the misconduct could cause a "significant loss of public trust if discovered." With such prevalence of misconduct, it should not be surprising that the Association of Certified Fraud Examiners (ACFE) reports approximately 5% of an organization's revenues are annually lost to occupational fraud, with a worldwide cost of $3.7 trillion annually (ACFE 2016).

Daigle, R., **McSwain, D.**, & Morris, P. (2016). The Enemies Within Your Organization: Occupational Fraud In the Oil, Gas and Energy Sector. *Oil, Gas & Energy Quarterly*, 2016, pages 889-898. https://store.lexisnexis.com/products/oil-gas-energy-quarterly-skuSKU10462/details.

THE ENEMIES WITHIN YOUR ORGANIZATION: OCCUPATIONAL FRAUD IN THE OIL, GAS AND ENERGY SECTOR

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Introduction

A headline like the following is definitely an attention grabber:

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This headline is from a March 2016 story about billionaire Babak Zanjani and two other individuals receiving the death penalty in Iran after being found guilty of embezzling $2.7 billion from the state-run National Iranian Oil Co. (Motevalli & Nasseri 2016). Arrested in 2013, an Iranian court determined the three individuals committed this massive fraud while attempting to circumvent international sanctions on Iranian crude exports. All three individuals are obviously appealing both their convictions and sentences.

Although the sheer size of this fraud (as well as the severity of the sentence) is eye-catching, the amount of fraud commonly committed by an organization's own employees also should be quite alarming to companies within the oil, gas and energy sector. This fact is demonstrated by survey results gathered by Big 4 firm KPMG about the current climate of business integrity. Of those surveyed who are employed in the "energy & natural resources" industry, 74% stated they had "personally seen" or had "first-hand knowledge of" misconduct within their organizations over the prior 12-month period (KPMG 2013). A clear majority of these same survey respondents also recognized the severity of the misconduct, with 53% noting the misconduct could cause a "significant loss of public trust if discovered." With such prevalence of misconduct, it should not be surprising that the Association of Certified Fraud Examiners (ACFE) reports approximately 5% of an organization's revenues are annually lost to occupational fraud, with a worldwide cost of $3.7 trillion annually (ACFE 2016). With respect to the "oil and gas" industry, the ACFE notes this group had the fifth-highest median loss by

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industry at $275,000 per occurrence of fraud.

Besides KPMG and the ACFE, other organizations that routinely gather information about occupational fraud include Marquet International and other Big 4 firms EY and PwC. The findings of all of these organizations reiterate the severity of occupational fraud both overall in business and within the oil, gas and energy sector. This article gathers and synthesizes the most recent findings of these organizations as well as news stories about fraud at oil, gas and energy companies to provide the following insights:

- The nature and scope of occupational fraud,
- How occupational fraud is most often committed in the oil, gas and energy sector, and
- How occupational fraud can be reduced.

Understanding these particular matters is a crucial first step in assisting organizations in the oil, gas and energy sector in order to combat fraud committed by their own employees. Coupling this knowledge with a proactive approach of implementing better internal controls, organizations can better protect themselves from the unfortunate enemies within their business—their employees.

Nature of Occupational Fraud

To appreciate fully the significance of occupational fraud, one must understand its nature and scope. In the ACFE's biannual *Report to the Nations on Occupational Fraud and Abuse* (ACFE *Report*), occupational fraud is defined as:

> *"The use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets"* (ACFE 2016).

Key words in this definition include "deliberate," "misuse," "misapplication," and "employing." To elaborate, occupational fraud goes beyond the theft or embezzlement of an asset from an employer (such as taking cash or other assets). It includes the misuse of resources or assets (such as personal use of company equipment) or misapplication of resources or assets (such as manipulating the financial statements of the organization to deceive the various decision-makers using those statements).

Along with the ACFE, other organizations concerned with fraud use a similar meaning and scope when gathering information about occupational fraud and misconduct. KPMG's *Integrity Report 2013* focuses on stealing and deceit to defraud one's own employer, as well as other forms of misconduct such as discrimination, sexual harassment, creating a hostile work environment, and violating workplace policies and rules (KPMG 2013). While PwC's *Global Economic Crime Survey 2016* draws attention to external culprits, it also highlights those internal to the firm who defraud their employers (PwC 2016).

Results reported in EY's *12th Global Fraud Survey* focus more on certain types of occupational fraud perpetrated by those at the top of the organization and in management/supervisory positions, such as bribery and fraudulent financial reporting (EY 2013). *The 2013 Marquet Report on Embezzlement* (*Marquet Report*) focuses on embezzlement, which is a particular type of occupational fraud that can be committed by any employee (and is therefore commonly referred to as "employee fraud") (Marquet International 2013). The theme that is seen throughout these attempts at identifying and reporting on occupational fraud is that there are many ways in which an employee can deliberately misuse or misapply the resources of one's employer for one's own personal enrichment and benefit.

The ACFE *Report* provides an extensive overview and classification of occupational fraud techniques that fall into three categories (ACFE 2016):

- **Asset misappropriation**, which includes theft of cash, inventory and other assets, as well as their misuse;
- **Financial statement fraud**, which includes manipulating financial statements and/or footnote disclosures; and
- **Corruption**, which includes employee conflicts of interest, bribery, illegal gratuities, and economic extortion.

The biannual ACFE *Report* consistently finds that in terms of frequency, asset misappropriation is the most prevalent category of occupational fraud by occurrence, followed by corruption and then financial statement fraud. However, with respect to cost per occurrence, the order is the exact opposite with financial statement fraud the most costly, followed by corruption and then misappropriation of assets. To appreciate the significance of these findings, one must understand the nature of each category of fraud, who typically commits each category, and for what purpose the fraud is committed.

As mentioned previously, misappropriation of assets is commonly referred to as "employee fraud" since any employee may steal or misuse assets of his or her employer. Given the range of possible culprits (all employees), this category of fraud is typically the most prevalent. However, it generally is the least costly per occurrence in comparison to the other two categories.

At the other end of the spectrum is financial statement fraud, a type of occupational fraud involving the manipulation of financial statement information for the purpose of misleading decision-makers into acting in a manner contrary to the actions they would have acted had the financial statements been properly stated. This category of fraud is commonly referred to as "management fraud" because executive managers are generally the only people with the capability to commit financial statement fraud via overriding controls. With a much smaller portion of employees able to commit this fraud, it occurs less frequently than the other two categories. However, because the purpose of this type of fraud is to manipulate the decisions of financial statement users, it is the most costly per occurrence.

Corruption is the third category of occupational fraud. Corruption falls between the other two categories in terms of frequency and cost per occurrence, because the number of employees (typically in the roles of managers and supervisors within an organization) is larger than the number of those who can commit financial statement fraud and lower than the number of those who can commit misappropriation of assets. Corruption schemes are typically more costly than the theft or misuse of an asset but typically not as costly as the impact financial statement fraud has on the decision-makers manipulated.

Now that the general nature of occupational fraud has been defined, it is important to gain a deeper perspective on how occupational fraud most frequently occurs within the oil, gas and energy sector. Three recent reports provide excellent insights into the frequency of occupational fraud in this industry—the ACFE *Report*, the *Marquet Report*, and the KPMG *Integrity Report*. The oil, gas and energy sector ranks eleventh by industry in the ACFE *Report* in terms of frequency (3.4%) and fifth in terms of median loss per occurrence ($275,000) among more than 20 industries. The sector ranks 18th in terms of frequency among more than 30 industries covered in the 2013 *Marquet Report*. KPMG's *Integrity Report 2013* states the "energy and natural resources" industry ranks ninth among 13 industries. These findings triangulate to highlight the fact that organizations in the oil, gas and energy sector should be concerned about occupational fraud within their businesses, which raises the question: How exactly is occupational fraud perpetrated within these businesses? The next section of this article answers this question by delving into the most common fraud schemes that occur within the oil, gas and energy sector.

Common Fraud Schemes in the Oil, Gas and Energy Sector

The ACFE *Report* provides an insightful breakdown of the frequency of fraud schemes for 15 industries. The following table details the 10 most frequent schemes for oil and gas industry fraud.

Table – Percentage Frequency of Schemes for the Oil and Gas Industry, per 2016 ACFE *Report to the Nations on Occupational Fraud and Abuse*

Scheme	Percentage of Cases*
Corruption	48.6
Billing	20.3
Non-Cash	17.6
Expense Reimbursements	10.8
Cash on Hand	9.5
Payroll	8.1
Skimming	8.1
Financial Statement Fraud	6.8
Cash Larceny	4.1
Check Tampering	4.1

* Column does not add to 100% because some cases of fraud involved multiple schemes

ocusing attention on the top four most frequently occurring fraud schemes shown in the table, it is important to understand the nature of each of the schemes that occurs most frequently in the oil and gas industry. Corruption is the most frequent scheme perpetrated in oil and gas. As a reminder, the ACFE *Report* describes corruption as involving employee conflicts of interest, bribery, illegal gratuities, and economic extortion. The $2.7 billion fraud noted at the beginning of this article involved not only embezzlement but also corruption. This massive fraud illustrates an important point about how fraudsters often perpetrate multiple schemes at once. It also serves as an excellent example of another ACFE *Report* finding—corruption appears to be the "most compatible" with other schemes perpetrated. The motivation behind the embezzlement was to circumvent international sanctions on Iranian crude exports. Babak Zanjani had the opportunity through his "good contacts with Iran's Revolutionary Guards" under the former presidency of Mahmoud Ahmadinejad, which allowed Zanjani to embezzle and use the Tajikistan branch of his own bank, First Islamic Investment Bank, to move the money out of Iran (Motevalli & Nasseri 2016).

As can be seen from this Iranian example, having the assistance of government officials (the "tone at the top" of a nation, state, or community) can allow such frauds to occur and be quite costly. As another recent example, Brazil's Supreme Court decided in March 2016, to put Eduardo Cunha, speaker of the lower house of Brazil's Congress, on trial for allegedly accepting "$5 million in bribes as part of a vast embezzlement and bribery network" involving Brazil's national oil company, Petrobras (Wroclavsky 2016). In yet another recent example, a Venezuelan national pleaded guilty in March 2016, to federal bribery charges between his United States-based energy businesses and Venezuela's state-run oil company, PDVSA (Graczyk 2016). Four others pleaded guilty in late 2015–early 2016, while another individual will face trial in April 2016. The bribery of PDVSA officials (a violation of the Foreign Corrupt Practices Act) included money, recreational travel, meals and entertainment, and a mortgage payoff for obtaining lucrative multimillion dollar contracts and placement on PDVSA's approved vendor listing for priority payments. With these three recent international examples, it should be no surprise that the ACFE *Report* notes that corruption is a worldwide issue, with the Middle East/Northern Africa and Latin America/Caribbean (two major oil and gas regions) ranking first and second, respectively, in median loss from corruption (ACFE 2016).

Billing schemes are the second most frequent type of fraud perpetrated in the oil and gas industry per the ACFE *Report*. At a percentage of 20.3%, billing schemes are defined as:

> *A fraudulent disbursement scheme in which a person causes his or her employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases* (ACFE 2016).

As can be seen in the definition, billing schemes can take a variety of forms. One means of doing so is having invoices for an employee's own personal purchases paid directly by his or her employer. Another means is to cause the overpayment or double payment of invoices on purpose to a legitimate vendor and then having the payment returned directly to the employee in the company causing the overpayment. This process is often referred to as either a “pay and return” scheme (Wells 2002) or “non-accomplice vendor” billing scheme (ACFE 2016).

Another example of a billing scheme is for an employee to create a dummy company that provides no goods or services (a shell company) or a company that provides real goods or services but at inflated prices (a pass-through company) for the purpose of stealing from the employer. The 2013 *Marquet Report* provides an excellent example of this type of disbursement fraud in the oil and gas industry. In 2013, Henry Kunter was sentenced to eight years for embezzling $136,000 from the Vail-Eagle (CO) Valley Rotary Club, where he served as treasurer, and $88,000 from Crystal River Oil and Gas, where he worked as a bookkeeper. Kunter wrote checks to dummy companies that he created and controlled that did not provide any goods or services to either organization he defrauded. The *Marquet Report* adds an additional piece of information about the fraudster—Kunter taught principles of accounting at a local community college while he perpetrated his frauds.

The third most common scheme in the oil and gas industry is non-cash fraud at a frequency of 17.6%. This scheme can also take many forms, including both outright theft of assets and the misuse of assets and resources of an organization (for example, the theft or misuse of confidential client, vendor, or employee information). The fourth most common scheme is expense reimbursement at a frequency of 10.8%. Examples of this scheme include mischaracterizing personal expenses on an employee’s request for reimbursement, overstating expenses, fictitious expenses (the last two of which can occur when receipts are not required and per diem amounts are used instead), and multiple reimbursements (i.e., requesting the same reimbursement multiple times).

Although financial statement fraud is not among the top four most common fraud schemes in the oil and gas industry, it is the most costly per occurrence. Like billing schemes, this category of fraud also can take many forms and is very dependent on whether the motive is to make the financial statements look better or worse than they actually are. If the motive is to attract investors, the financial statements are made to look better and more profitable than the actual financial condition of the organization. If the motive is to reduce income tax, the financial statements are made to look worse so a lower profit is reported. The ACFE *Report* notes a number of basic types of financial statement fraud. These include (ACFE 2016):

- Timing differences, such as recording transactions in the wrong accounting period;
- Fictitious (overstated) or understated revenues;
- Concealing (understating) or overstating liabilities and related expenses;
- Improper asset valuations, such as the allowance for doubtful accounts or depreciation expense; and

- Improper disclosures.

Many oil and gas organizations deal with challenging, complex, and subjective estimations in their everyday business that lend themselves to an opportunity to manipulate their financial statements, especially improper asset valuations. However, keep in mind that some financial statement frauds can be very basic, such as simply failing to record items in the correct accounting period or failing to record vendor invoices and related expenses. Organizations need to be diligent with preventing and detecting fraud in its many forms and methods. On this topic, the next section discusses how occupational fraud can be both better prevented and better detected by oil and gas organizations.

Reducing Fraud in the Oil, Gas and Energy Sector

A number of the organizations referred to in this article (ACFE, Marquet International, KPMG, PwC, and EY) have *repeatedly* gathered information about fraud over time and reported very similar findings from one report to the next. For example, the ACFE issued its first report in 1996 and has done so biannually every year since its second report in 2002. Marquet International has issued a number of consecutive yearly reports, and EY has habitually issued reports on fraud, with its 12th being the latest. Although exact numbers and percentages may be different from one report to the next, findings are largely consistent over time. Clear fraud is a continuing issue and that turning away and failing to address these findings will cause the same frauds to continue at the same amounts (or even larger) and continue to be documented in future reports.

There is probably no way to completely eliminate or eradicate fraud. Management override and collusion will always provide an opportunity for fraud to occur. In fact, these two inherent weaknesses in every system of internal control cause the largest fraud losses. Management override is always present with financial statement fraud, the most costly of all frauds. Override is also often present in corruption, which involves the misuse of one's responsibilities (often managerial or supervisory) at the expense of the employer and enrichment of the fraudster. Collusion among multiple employees with independent duties also will make fraud easier to perform and more costly to organizations. This fact is noted by the ACFE when reporting that the median fraud loss committed by a single person is \$85,000, while the median fraud loss exceeds \$633,000 when committed by five or more individuals (ACFE 2016). Unfortunately, these inherent weaknesses will always give rise to the opportunity for fraud.

In spite of the bleak assessment above, there are both general and specific actions that companies in the oil, gas and energy sector can take to combat fraud. First, an organization must have a strong control environment. An organization should have a strong board of directors and audit committee to both oversee management and set the tone for all employees. In fact, EY emphasizes the importance of the control environment in its *12th Global Fraud Survey* when stating that in many organizations "the tone at the top (is) diluted by the failure to penalize misconduct" (EY 2013). Although some readers may view the death sentence for the \$2.7 billion fraud discussed earlier in this article as rather extreme, there is no doubt this misconduct is not being tolerated. Penalizing fraudsters can serve as deterrence for other fraudsters, especially when management sets the proper tone with its own ethical behavior to be modeled by employees.

Another suggestion is one that has been highlighted in many reports by the ACFE—since tips, particularly from employees, constitute the number one way in which frauds are most likely to be detected, it is important to provide a hotline for employees and others to use to report fraud (ACFE 2016). Multiple ACFE reports show a trend of approximately 40% of frauds detected by tip. Of these, over half of the tips in the 2016 *Report* were from employees. An employee stepping forward to report a fraud has faith in management to do the right thing by ending the fraud and punishing the fraudster. Reiterating the importance of the control environment, a hotline will be most effective when employees clearly see a strong tone at the top of the organization.

Bringing attention back to the most frequent fraud scheme in the oil, gas and energy sector, corruption may be reduced not only by having a strong control environment, but by also implementing particular policies and procedures. These include having a code of conduct, policies on accepting gifts, and fraud training for all employees, including management. Another suggestion is to rotate duties and enforce vacation. While these techniques may not prevent fraud such as corruption from occurring, it can detect it and may even deter it if the employee knows he/she will have new duties after a certain period in the current position or have someone temporarily perform their responsibilities while on forced vacation.

Yet another suggestion for reducing corruption is to implement a strong monitoring program that oversees proper implementation and maintenance for following the Foreign Corrupt Practices Act. As noted earlier in this article, the bribery of officials with Venezuela's state-run oil company, PDVSA, by individuals from the United States on behalf of their energy companies was a violation of the Act. United States organizations involved in global activities often deal with values and morals deemed unacceptable in their home country—for example, payments to a governmental official for the purpose of obtaining business in that location. The fact is, although something like a payment to a governmental official may not be considered wrong in another location of the world, if it is deemed illegal in the United States (where it is referred to as "bribery"), businesses must ensure they are complying with the Act.

Definite procedures can be put in place to combat the other most frequent frauds committed in the oil, gas and energy sector that involve misappropriation of assets (billing schemes, non-cash fraud, and expense reimbursement schemes). Referring to the billing scheme by William Kunter discussed earlier in this article, separating the duties of recordkeeping and custody/authorization over checks would better prevent such frauds from occurring. Having an authorized check signer review complete documentation for each disbursement (typically the three-way match of purchase order, receiving report, and vendor invoice) before signing checks also can reduce this fraud from occurring. Another strong control would be requiring two check-signers for disbursements over a certain amount.

Another suggestion is not to give the accounts payable function the ability to add new vendors. This authorization ability provides the opportunity to add dummy vendors, which was involved in the Kunter fraud. Another suggestion is to have someone with non-cash duties reconcile the bank account. Referring back to the Kunter fraud, it would be no surprise if as bookkeeper he also had check custody, check-signing authorization, and reconciliation duties over the bank account. Separating these duties would reduce the ability to commit dummy company disbursements. Yet another suggestion for this fraud was discussed as a way to reduce corruption—rotating duties and enforced vacation. Besides making sure employees in the accounting department are cross-trained and prepared to take on a task in an unforeseen situation, rotating duties and mandatory vacations can detect and even deter fraud.

With respect to non-cash fraud, stronger physical and logical access controls can help reduce this particular category. For expense reimbursement schemes, careful review by supervisory and managerial personnel of all supporting documentation for proper business reasons can help reduce fraud losses. While these past few statements and those in the past two paragraphs speak directly to particular suggestions unique to a given fraud, we cannot help but reiterate the importance of the control environment. Executive management commits financial statement fraud, while both managers and supervisors typically perpetrate corruption schemes. Although the individuals in these positions may be hiding their fraudulent activities, their behaviors may not exude the proper tone at the top of the organization for all employees to model and emulate. Quite possibly using the poor tone as a rationalization, employees may then seek their own ways to commit fraud as well. Proper policies and procedures are important, and so are the people within the organization. An organization cannot be too trusting when giving responsibilities and duties to employees, but it must make the effort to implement a strong control environment that firmly communicates to employees that management does not tolerate fraud and that fraudsters will be punished. If these suggestions are followed, perhaps the findings reported the next time by the ACFE, Marquet International, KPMG, EY, and PwC will be quite different because of a reduction in occupational fraud.

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