*Environmental Audit and*

*Financial and Compliance Auditing*

*Mehemea Kei te ora a Papatuanuku ka ora te tangata*

*(If we nurture Mother Earth then she will nurture us)*

# Table of contents

[Introduction 3](#_Toc421529234)

[General concepts 3](#_Toc421529235)

[The nature of environmental auditing 4](#_Toc421529236)

[Financial and Compliance Audit 5](#_Toc421529237)

[Financial Audit 5](#_Toc421529238)

[Environmental matters 6](#_Toc421529239)

[Cash versus accrual accounting 7](#_Toc421529240)

[How Environmental Issues Impact on Financial Statements 8](#_Toc421529241)

[Cash accounting 8](#_Toc421529242)

[Accrual accounting 9](#_Toc421529243)

[Compliance Audit 11](#_Toc421529244)

[Consider laws and regulations 14](#_Toc421529245)

[Dealing with environmental issues in financial and compliance audits 15](#_Toc421529246)

[Obtain knowledge of environmental matters 15](#_Toc421529247)

[Assess inherent risk, internal control systems, and the control environment 16](#_Toc421529248)

[Audit Criteria 17](#_Toc421529249)

[Perform substantive procedures 18](#_Toc421529250)

[Reporting 19](#_Toc421529251)

[Governmental reporting on environmental issues 19](#_Toc421529252)

[Sustainability reporting 20](#_Toc421529253)

# Introduction

1. Professional standards and guidelines are essential for the credibility, quality and professionalism of public-sector auditing. The International Standards of Supreme Audit Institutions (ISSAIs) developed by the International Organisation of Supreme Audit Institutions (INTOSAI) aim to promote independent and effective auditing and support the members of INTOSAI in the development of their own professional approach in accordance with their mandates and with national laws and regulations.
2. *ISSAI 100 - Fundamental Principles of Public-Sector Auditing* provides the fundamental principles for public-sector auditing in general and defines the authority of the ISSAIs. *ISSAI 200 - Fundamental Principles of Financial Auditing* has been developed to address the key principles related to an audit of financial statements in the public sector, whilst *ISSAI 400 - Fundamental Principles of Compliance Auditing addresses* the specific context of compliance auditing.
3. ISSAI **1000 to 2999** *[currently under review and update]* categorised by INTOSAI Auditing Standards Committee as level four general auditing guidelines on **financial audit**, provide guidance for conducting financial audits of public sector entities on the basis of the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) and the practice notes which are part of these guidelines.
4. ISSAI 4000-4999 General Auditing Guidelines on Compliance Audit *[currently under review and update]* provide guidelines on conducting compliance audit related to financial statements and also compliance audit performed separately.
5. ISSAI 5120 *Environmental Audit and Financial and Compliance Auditing,* belongs to the group of ISSAI guidelines on specific subjects and has been developed by the INTOSAI Working Group on Environmental Auditing (WGEA). The document reflects the experiences and good practices of the SAIs and serves as a tool in assisting auditors in conducting audits with an environmental focus.

# General concepts

1. This guideline is based on generally accepted principles of financial and compliance auditing as introduced in ISSAI 200 and ISSAI 400, and current good practice in environmental auditing. It primarily covers environmental issues in the context of financial and compliance audits and has been written to meet the needs of this entire area.
2. A supreme audit institution (SAI) does not need to have a specific mandate to conduct environmental audits and may perform such audits under the general authorization to conduct financial or compliance audit.
3. Environmental auditing is usually defined as an audit addressing the approach taken by responsible bodies (e.g. government) to a specific environmental problem or environmental policy area. [awaits confirmation from the WGEA]
4. An SAI may feel that its greatest skills and experience lay in the audit of financial and compliance issues. It would be, therefor essential for them to use this experience in an environmental audit. This paper illustrates the possibilities for conducting audits with an environmental focus using a financial and compliance framework.
5. The introduction and general concepts provide the necessary background to the guideline, while the four following sections specify the overall nature of environmental auditing, specifically in the context of financial and compliance auditing - and how to do it - based on current practices. Relevant examples of environmental financial and/or compliance audits all over the world are provided. One source of further audit case studies is the INTOSAI WGEA webpage and the Greenlines Newsletter.
6. The first section of this ISSAI introduces the nature of environmental auditing, setting out the character of financial, compliance, performance, and sustainable auditing.
7. Section two describes in details the purpose, objectives and various approaches to financial and compliance auditing. In particular the characteristics of cash and accrual accounting when dealing with environmental auditing is considered.
8. The third section sets out specific methods and techniques as to how the auditor obtains knowledge of environmental matters and assesses inherent risks, how laws and regulations are considered, how audit criteria are defined, and how to perform substantive auditing procedures.
9. Finally the fourth section provides information on governmental reporting on environmental and sustainability issues.

# The nature of environmental auditing

1. Accountants and auditors have traditionally not been associated with environmental policy. However, as providers of information, reports, and assurance on which business and government decisions are frequently based on, they have increasingly been drawn into the environmental arena. The influence of accountants and auditors comes from their access to financial and performance information. They analyse, report and communicate information on which decisions are based and performance is evaluated. They can encourage greater transparency and informed decisions about the application of resources and the impact of activities on environmental outcomes without distorting existing accounting standards.
2. The costs to governments of developing and implementing environmental policies and obligations are increasingly significant. An SAI should recognize that environmental costs, liabilities and asset impairments affect the preparation and audit of financial statements. Accordingly, the auditor will need to assess the completeness and accuracy of the figures reported.
3. The objective of an audit of financial statements is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. Material respects can be directly linked to environmental costs, obligations, impacts, and outcomes. The audit of financial statements requires the auditor to consider environmental matters as part of the audit.
4. During an audit of **financial statements**, the following environmental issues may arise[[1]](#footnote-1):
* initiatives to prevent, abate or remedy damage to the environment;
* the conservation of renewable and non-renewable resources;
* the consequences of violating environmental laws and regulations; and
* the consequences of vicarious liability imposed by the state.
1. **Compliance auditing** with regard to environmental issues may relate to providing assurance that governmental activities are conducted in accordance with relevant environmental laws, standards and policies, both at national and international (where relevant) levels.
2. Performance auditing of environmental activities may include ensuring that:
* indicators of environmental-related performance (where contained in accountability reports) fairly reflect the performance of the audited entity; and
* environmental programmes are conducted in an economical, efficient, and effective manner.

For more detailed guidelines on performance auditing of environmental activities the reader may refer to the INTOSAI WGEA’s guideline ISSAI 5110 *Conducting Audits of Activities with an Environmental Perspective*.

1. While this paper discusses environmental auditing in the context of financial and/or compliance audit, it is acknowledged that audits of sustainable development may be approached in ways similar to those described here. The reader may refer to the INTOSAI WGEA’s guideline ISSAI 5130 *Sustainable Development: The Role of Supreme Audit Institutions* for further information on this matter.

# Financial and Compliance Audit

1. A financial and compliance audit embraces:

• attestation of financial accountability of accountable entities, involving examination and evaluation of financial records and expression of opinions on financial statements;

• attestation of financial accountability of the government administration as a whole;

• audit of financial systems and transactions including an evaluation of compliance with applicable statutes and regulations;

• audit of internal control and internal audit functions;

• audit of the probity and propriety of administrative decisions taken within the audited entity; and

• reporting of any other matters arising from or relating to the audit that the SAI considers should be disclosed.

1. This guideline also acknowledges that whereas compliance with environmental laws and regulations can be considered in a separate audit, it can also be part of a performance audit. For guidance on performance audits with a particular environmental focus, please consult ISSAI 5110.
2. The environmental audit in the context of financial and/or compliance audit may be in relation to compliance with accounting standards and/or compliance with relevant environmental laws and treaties.

## Financial Audit

1. The purpose of financial statements is to provide information on the financial position, performance, and cash flow of an entity that is useful for making and evaluating decisions about the allocation of resources. Specifically, a financial statement in the public sector should provide useful information for decision-making and demonstrate an entity’s accountability for its resources.[[2]](#footnote-2)
2. Generally, financial statements of governments (or their constituent entities) have tended to avoid environmental issues. However, there is a realization that there are costs, compliance, and performance issues associated with environmental policies and obligations that should be reflected in financial statements.
3. Financial auditing traditionally deals with financial information. It has a direct link with the financial accounting system and is expressed in monetary units. However, information can be material even if it is not presented in monetary terms. Non-financial information can include units such as tons of greenhouse gas, cubic meters of water consumption or share of eco-labelled products. Non-financial information might be more difficult to understand and interpret compared with financial information because there might not be generally accepted reporting principles or authoritative sources of criteria or the information might be qualitative in nature. Despite these challenges, non-financial information might be very relevant for any audit dealing with the environment.

**[Example to be updated]**

**United Kingdom Atomic Energy Authority (UKAEA) Annual Accounts for 2002–03**

The accounts of the United Kingdom Atomic Energy Authority for 2002–03 include the following disclosures:

• A performance report based on an environmental performance index -a numerical measure that promotes first class environmental management. The environmental management plans in place at UKAEA support their certification under the ISO 14001 environmental standards.

• A report on the main features of the environmental restoration for all sites for which the UKAEA is responsible.

• Detailed disclosures on the costs of decommissioning and restoring nuclear sites and the estimates of cost are calculated.

1. The objective of an audit of financial statements is for the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.[[3]](#footnote-3)

### Environmental matters

1. Environmental matters have become significant to an increasing number of governments, entities, and users of financial statements. Some organizations operate in sectors where environmental matters may have material impacts on their financial statements. Possible environmental issues arising during the audit of financial statements are referred to in paragraph 18.
2. To date, the accounting and auditing communities have focused on environmental liabilities. While an organization’s financial statements may include land assets (valued on the same basis as other property), a recent focus has been on “environmental assets” - natural assets that do not provide resource input but which provide ecosystem services such as habitat or flood and climate control, and other non-economic functions such as aesthetic or health values. This idea stresses that bodies are accountable not only to their shareholders but also to society for the stewardship of the natural environment. The consideration of environmental assets is still at an early stage of development, with the private sector very much taking the lead.
3. Financial accounting systems are not designed to take into account the risks associated with the biodiversity and ecosystem services. The degradation of these services, however, poses serious risks to societies and their economies and therefore the potential for increased costs. The following box provides examples of possible ecosystem services and the experience of the OAG of Canada in auditing services concerning biodiversity.

**Ecosystem services**

According to the UN Millennium Ecosystem Assessment, ecosystem services are benefits people obtain from ecosystems. These include food, water, timber, and fiber, as well as regulating services that affect climate, floods, disease, and water quality. Also supporting services, such as soil formation, photosynthesis and nutrient cycling are part of the services, and finally the recreational, aesthetic and spiritual aspects can be included. According to the FAO, the monetary value of pollination services only could be as high as 200 billion dollars annually. Biodiversity is also a major source of ingredients for medications.

The OAG of Canada paid attention to the importance of biodiversity in their audit on meeting the Goals of the International Convention on Biological Diversity. Canadian Department of Fisheries and Oceans found in 2011 that products and outputs of the commercial fishing, aquaculture, and fish processing industries were valued at approximately $7.4 billion and employed close to 85,000 people across Canada. The Canadian forest service found that the forest industry accounted for about $23.7 billion in economic activity, or nearly 2 percent of Canada’s gross domestic product, and employed almost 234,000 Canadians, and the Parks Canada that Canada’s national parks and marine conservation areas generated nearly $3 billion in cultural services and close to 42,000 jobs.

OAG 2013 Fall Report of the Commissioner of the Environment and Sustainable Development. <http://www.oag-bvg.gc.ca/internet/docs/parl_cesd_201311_02_e.pdf>

1. Even if evaluating ecosystem services might be challenging, auditors could make their governments aware of the importance of the topic. Auditors could also urge governments to take into account the environmental matters in their annual financial reporting.

### Cash versus accrual accounting

1. Public sector reporting is a spectrum between cash accounting and accrual accounting. Governments around the world adopt a variety of reporting practices along this spectrum.[[4]](#footnote-4)
2. The cash basis of accounting recognizes transactions and events when cash (including cash equivalents) is received or paid. It measures the overall financial results for the period as the difference between cash received and cash paid. The primary financial statement is the cash flow statement.
3. In comparison, the accrual basis of accounting recognizes transactions and other events when they occur (not just when cash and its equivalent are received or paid). The elements in a financial statement under accrual accounting are assets, liabilities, net assets and equity, revenue and expenses.
4. This guideline discusses the impact of environmental issues on financial statements prepared using both methods of accounting and what a SAI should consider when auditing financial statements.

## How Environmental Issues Impact on Financial Statements

### Cash accounting

1. Environmental issues can impact on financial statements prepared on a cash basis of accounting, but the effects are limited because a cash basis focusses on the recognition of impacts during the accounting year in question (through specific payments and, in statements of losses, through special payments). Environmental impacts are not necessarily restricted to specific periods and may need to be projected. Therefore, auditors may consider developing a methodology to examine the impacts of activities on environmental issues for periods longer than the accounting year in question***.*** Methods like effective monitoring may, therefore, facilitate an impact examination. This requires, however, that the main objectives and intermediate indicators are clearly defined.
2. In addition, there could be an impact on financial reporting where compliance reporting is included in a government financial report, for example, where the entity is required to demonstrate compliance with environmental laws and regulations. Non-compliance can be reported through specific details or special reports that use financial and compliance auditing principles.

**[Example to be updated]**

**Apollo Sea Oil Spill - Republic of South Africa**

In the mid-1990s, an oil spill off the western cape shores of South Africa polluted some of the most scenic coastline of the area, a popular tourism area renowned for its natural beauty.

The responsibility for dealing with the oil spill was shared between various government agencies, but the insurance policy for recovery of the costs was vested with a government department that prepares its financial statements on the cash basis of accounting.

Additional disclosure of various items was required, including losses, incurred liabilities, and contingencies. The settlement of accounts with service providers and the finalization of the insurance claim dragged on over a number of financial periods, making the disclosure of the real cost in the cash accounts inconclusive. The effect on additional disclosures had to be considered continually. This meant the auditors had to monitor the situation over a number of financial periods until its resolution, even though it was predominantly linked to a cash basis of accounting.

The insurer offered a ZAL 15 million settlement based on the individual figures available, whereas a comprehensive analysis showed that some ZAL 25 million had been expended by the different agencies. As the responsibility was shared between various agencies, these considerations were relevant to various audits.

In this situation the SAI was able to comment in a special report on the full cost of the environmental incident and on the coordination issues between the various agencies, something that might not have been appropriate in separate audit reports on each agency.

There are other instances when the auditor may take into account the fact that while a particular issue may not be material within a single agency, it might be important across a number of agencies. For example, efficient energy management within a single agency may not be significant but across a number of agencies could lead to considerable savings.

**[Example to be updated]**

**Drilling and maintenance of boreholes - Zimbabwe**

This was an audit of a District Development Fund (DDF) that had, as one objective, to provide safe drinking water to rural people by sinking boreholes owned by and located in communities. The shortcomings reported to Parliament included:

• the financial management and control system was not favourable to provincial drilling operations;

• borehole drilling services were provided to people who were outside the DDF mandate; and

• the DDF managed to achieve only 45 percent of its planned output during the audited period.

### Accrual accounting

1. Environmental issues can have an impact on financial statements prepared on an accrual basis in many ways. There are international accounting standards that address the general principles for the recognition, measurement, and disclosure of environmental matters in a financial report.[[5]](#footnote-5) SAIs may, therefore, develop auditing standards in line with these accounting standards in conjunction with their own national accounting bodies, or simply adhere to the internationally accepted auditing standards for financial audits as described in this paragraph. The following situations are consistent with this standard.
2. The introduction of environmental laws and regulations may involve an obligation to recognize impairment of assets and consequently a need to write-down the carrying value*.*
3. Failure to comply with legal requirements concerning environmental matters, such as emissions or waste disposal, may require the accrual of remediation works, compensation, or legal costs, for example a failure to comply with pollution control laws may lead to fines and penalties for an entity[[6]](#footnote-6).
4. Some annual operating costs are environmental in nature. For example, energy costs can be considered an environmental cost as the use of fossil fuels is a source of carbon dioxide and air pollution.
5. Some entities may need to recognize environmental obligations as liabilities in the financial statements. For example, obligations associated with solid waste landfill closure, and aftercare and restoration obligations associated with mining operations.
6. An entity may need to disclose a potential environmental obligation as a contingent liability where:
* the possible obligation depends on the possible occurrence of a future event; or
* the amount of the present obligation cannot be reasonably estimated; or
* an outflow of resources to settle the obligation is not probable.
1. In the course of meeting the relevant accounting standard requirements, some additional disclosures in the notes to the financial statements may be required. Examples include:
* the industry in which the entity operates and the associated environmental issues;
* the accounting treatment adopted for environmental costs (i.e. what is included, when items are expensed or capitalised, how items are amortised to income, etc.);
* fines and penalties which have been incurred under environmental legislation; and
* environmental restoration liabilities, including measurement uncertainties, nature, and timing.
1. Regardless of the increasing emphasis on environmental accounting, the accrual accounting regime not only recognizes environmental costs as they occur (as cash accounts, etc.) but also recognizes items such as environmental liabilities, either in the long or the short term - for instance, by establishing financial provisions in the balance sheet and by disclosing contingent liabilities elsewhere in the financial statements. The value of fixed assets can also be adjusted - through permanent devaluations, for example, to reflect impairments. Existing international accounting standards, therefore, recognise environmental issues. Auditors can use these standards to assess the inclusion of environmental issues in the financial statements, or they can benefit from the internationally accepted auditing standards that cover the above mentioned situations. The following is a relevant example of the audit work performed by the UK NAO in order to provide reasonable assurance that the accounts are free from material misstatement.

**The UK’s Coal Authority accounts 2013-14**

UK’s Coal Authority was established when the UK’s coal industry was privatised, to take on responsibility for licensing coal mining activities and to deal with mine water and subsidence legacy issues from the coal and metal mining sector. It works to protect the public and the environment, manage its legacy property portfolio, and realise value from and provide access to information it holds.

The Authority’s annual report presents its performance, including in relation to:

* Operating and developing new mine water treatment schemes
* Investigation and repair associated with incidents potentially impacting on public safety and subsidence
* Inspecting and monitoring closed mines’ waste tips and entries and regulating activities which may impact on coal sites, to ensure that the necessary risk assessment of water, gas and ground stability is carried out.

The Authority’s accounts are prepared to UK public reporting requirements, which apply the requirements of the International Financial Reporting Standards. They are prepared under the historical cost convention, modified to account for the revaluation of investments, property, plant and equipment and intangible assets. The accounts therefore include provisions for estimated future expenditure relating to its legacy liabilities, over periods of 50 to 100 years into the future. In 2013-14 the provisions decreased from £1,067.0 million to £1,066.0 million. The accounts provide information on the high level of sensitivity of the provisions balance to trends, assumptions and changes to the discount rate.

The inclusion of these provisions results in the accounts showing net liabilities, totalling £975.7 million at 31 March 2014, and so raising a question as to whether the Authority is a “going concern”. The Report confirms that the accounts have been prepared on a going concern basis because the Authority has a reasonable expectation that it will continue to receive Government funding to be able to meet its liabilities.

In accordance with International Standards on Auditing (UK and Ireland) the National Audit Office’s audit of the accounts must review the Authority’s estimation of its provision and obtain sufficient evidence to give reasonable assurance that it is free from material misstatement. This includes an assessment of whether the accounting policy for the provision is appropriate and is adequately disclosed. In addition the NAO must read all the financial and non-financial information in the Annual Report to identify material inconsistencies with the audited financial statements.]

## Compliance Audit

1. As stated in paragraph 2, compliance auditing falls within the INTOSAI standard ISSAI 400. Compliance audits can examine an entity’s compliance with a range of matters. Firstly, they can examine an entity’s compliance with financial authorities and accounting practices (for example, legislative controls such as appropriations of the entity’s spending). Secondly, they can examine compliance with environmental laws and treaties. Auditors may be interested in examining compliance with laws and treaties, as non-compliance could affect the entity’s financial statements. Also, auditors may be interested in examining such compliance because, apart from any effect on financial statements, it will inevitably incur expenditure and could, therefore, be relevant to the wider use of public funds.
2. Compliance auditing also allows the SAI to assess the compliance performance of an entity. It can help the government (and its agencies) close the gap between objectives set and the results achieved by policies and programmes. For example, a department may be funded to regulate environmental activities such as permits for the logging of trees. Where guidelines for the activity exist, does the department have the systems in place to do the job? Are its activities being fairly and accurately reported?
3. This type of environmental audit can:

• promote compliance or provide increased assurance about compliance with existing and impending environmental policy and legislation;

• reduce the risks and costs associated with non-compliance with regulations;

• save costs by minimizing waste and preventing pollution; and

• identify liabilities and risks.

The following example represents possible sources for formulating compliance criteria.

**Multilateral environmental agreements can help to formulate compliance audit criteria**

There are hundreds of Multilateral Environmental Agreements (MEAs) dealing with various environmental issues. MEA is a broad term including various kinds of conventions and protocols, but as INTOSAI WGEA and UNEP define it in their guidance, MEA is a legally binding instrument between two or more nation states that deals with some aspects of the environment.

If the country has signed MEAs, the most common approach is to evaluate how well the country has met its responsibilities and obligations under the MEAs, and how these responsibilities have been given effect by national legislation and governance. If a country has not signed MEAs, they can still be a good source of audit criteria as many agreements can be referred to as a best practice or benchmark. Also the reasons for not being a signatory to the MEAs can be brought to public attention.

As an example, in 2013, the SAIs of Denmark, Finland, Latvia, Lithuania, Norway, Poland and Sweden published a coordinated audit on Emission’s trading. The aim of the cooperative audit was to assess the trustworthiness, reliability and effectiveness of the European Union (EU) emissions trading scheme and the project-based mechanisms under the Kyoto Protocol.

Common audit criteria included both international agreements at the UN level, as well as European Union regulations and guidance on the subject matter:

1. The Kyoto Protocol and the relevant decisions of the Marrakesh Accords

2. The relevant EU directives

3. The registry regulation

4. UNFCCC monitoring and reporting guidelines

5. The EU monitoring and reporting guidelines

This is an example of auditing environmental cross compliance and the potential impact of its improper implementation.

**Case study – Cross compliance**

Under the European Union’s Common Agricultural Policy (CAP), the payments due to each beneficiary may be reduced if rules in the areas of environment, food safety, animal and plant health and animal welfare have not been respected, or if the requirement to maintain all agricultural land in good agricultural and environmental condition has not been fulfilled. This is called “cross compliance”.

Cross compliance does not involve the outlay of budgetary funds per se. On the contrary, infringements of cross compliance lead to reductions in payments to farmers. Although the amounts concerned (some 10 million euro in 2005) are limited, cross compliance applies to the implementation of a major part of the EU budget (around 40 billion euro) concerning around five million farmers.

The European Court of Auditors examined whether cross compliance was effective by analysing its introduction and the first years of its implementation by the European Commission and the Member States. More specifically, the audit answered the following questions:

* Are the objectives and the scope of cross compliance well defined, and can results be expected at farm level?
* Can the legal framework defining cross compliance be effectively implemented?
* Are cross compliance and rural development policy adapted to one another?
* Are the control and sanction systems effective?
* Is reporting and monitoring adequate?

The Court concluded that cross compliance is a vital element of the CAP. Where properly applied it has the potential to make EU farmers who receive CAP payments comply with rules relating to agricultural land, agricultural production and activity. However, Member States did not take their responsibility to implement effective control and sanction systems. Consequently, the control system provides insufficient assurance on farmers’ compliance. The sanction system is also not effective as the underlying principles are not sound.

<http://www.eca.europa.eu/Lists/ECADocuments/SR08_08/SR08_08_EN.PDF>

The example below demonstrates how the audit work contributes to reduce the risks and costs associated with non-compliance with regulations and the assessment of effectiveness of the respective scheme.

**Auditing environmental management systems**

In 2010 the State Audit Office of the Republic of Latvia (SAO) completed an audit on the compliance of an environmental damage compensation scheme with the relevant laws and regulations, which also examined the effectiveness of the scheme.

The scope of the audit included calculations of environmental damage caused to specially protected nature territories, micro-reserves, specially protected species and biotopes, waters, soil and subterranean depths, and the area of nature monuments and fisheries; as well as sustainable forest management and calculations of environmental damage caused to forests and hunting resources.

SAO also took into account research conducted by various independent experts, pointing out that sustainable management of State forests is currently not being sufficiently ensured. It explained that national laws do not require for an environmental impact assessment to be performed when several clear cuttings are being planned together in a forest - a loophole that is used at present by the largest State-owned forest management company, the State Joint Stock Company “Latvian State Forests”, which performs several clear cuttings together in a forest without conducting an environmental impact assessment.

During the audit the SAO established that the administration of compensation for damages caused to the environment, forests and hunting resources is not sufficiently effective, and that the existing system of penalties is not proportional - national laws contain no mechanism that would motivate violators to pay the administrative penalties imposed. The SAO pointed to the need to legally make penalties commensurate with the damages caused.

SAO also identified duplication of functions and poorly coordinated actions among the ministries involved with environmental protection and with the control of forest and hunting resources. This has resulted in a diminished capacity among enforcement authorities and an increased risk of undetected violations.

### Consider laws and regulations

1. The auditor should have a fundamental understanding of environmental laws and regulations that could result in the material misstatement of the financial statements or which may have a fundamental impact on the operations of an entity. The auditor is not expected to possess the expertise or professional competence to determine if an entity is in compliance with the environmental laws and regulations. The auditor, however, can use his/her training, experience and understanding of the entity and industry to recognize non-compliance issues and seek expert advice.
2. When planning and performing an audit, the auditor may evaluate compliance with applicable laws and regulations, where non-compliance may materially affect the financial statements, or where compliance incurs expenditure of public funds. However, an audit cannot be expected to detect non-compliance with all laws and regulations.[[7]](#footnote-7)

|  |
| --- |
| **Questions that might prompt possible environmental audit issues in terms of national and local government environmental legislation or policy** |
| Does the government have any stated **national environmental goals**?• Who developed them?• What do they aim to achieve?* Are results measured and reported?
* Who is responsible for aggregating the results?

• Do they establish standards or guidelines that must be complied with?* Have the standards or guidelines been communicated to those with responsibilities for protection, restoration, and management of the environment?

Does the government have any **entities or departments** that are responsible for the protection, restoration, and management of the environment?• What are the departments and their responsibilities?• How do they achieve the results (by regulation, policy, or management programmes)?* How do they report on their performance?
* Are there any joint responsibilities between entities or departments?

**Does the government** have relevant accounting standards?Has the government developed **legislation** designed to protect, restore, and manage the environment?• Are there laws that government departments are responsible for enforcing?* Who is responsible for enforcement and how do they enforce them?

• Are government departments required to comply with the environmental legislation or regulations?* Is there any other monitoring function that is responsible for compliance and reporting?
* If so, to whom are the reports directed?

  |

# Dealing with environmental issues in financial and compliance audits

## Obtain knowledge of environmental matters

1. In all audits, a sufficient knowledge of the business and significant risks is needed to enable the auditor to identify and understand matters that may have a significant effect on the financial statements, the audit process, and the audit report[[8]](#footnote-8).
2. The auditor is not expected to know more than management or the environmental experts. It is also possible to search for external experts’ help if needed, by using expert panels or focus groups, or by asking an independent expert(s) to give his/her opinion. In order to frame the request for expert advice and to understand the advice obtained, the audit team should have, at a minimum, an adequate core competence in the subject matter in question (see international auditing standards[[9]](#footnote-9)).
3. The auditor should consider the field or sector in which the entity operates, as it could indicate the possible existence of environmental liabilities and contingencies. Certain sectors are more exposed to environmental risks-for example, chemical, oil and gas, pharmaceutical, and mining industries, or government agencies with responsibilities for environmental management or regulation.

|  |
| --- |
| **Questions that might prompt possible dimensions of an environmental audit in terms of obtaining knowledge of the department or industry** |
| Does the government have any department/industry or agencies with activities that have an environmental impact?How have environmental risks been identified?Who within the department/entity is responsible for management environmental risks?Does the government department/industry or agencies operate in an industry that is exposed to significant environmental risk that may adversely affect the financial results and reports of the entity?Which environmental laws and regulations are applicable to the entity?Are there any substances used in the entity’s products or production process that are subject to particular law or regulations?Do enforcement agencies monitor the entity’s compliance with the requirements of environmental laws, regulations, or licenses?Have any regulatory actions been taken or reports been issued by enforcement agencies that might have a material impact on the entity and its financial results and/or report?Is there a record of penalties and legal proceedings against the entity or its directors in connection with environmental matters? If so, what were the reasons for such actions?Are any legal proceedings pending with regard to compliance with environmental laws and regulations?Are environmental risks/impacts covered by insurance? |

## Assess inherent risk, internal control systems, and the control environment

1. Having acquired a sufficient knowledge of the business, the normal procedure for the auditor is to assess the risk of material misstatement in the financial statements. In the context of environmental auditing this includes the risk of misstatement relating to environmental matters. This can be labelled environmental risks.
2. Examples of environmental risk include:

• costs arising from compliance with legislation; and

• impact of non-compliance with environmental laws and regulations.

1. The audited entity can adopt different approaches to achieve control over environmental matters. Small entities or entities with low exposure to environmental risk may include environmental control systems in their normal internal control systems. Entities with high exposure to environmental risk may design and operate a separate internal control sub-system, for example, an environmental management system (EMS).[[10]](#footnote-10)
2. The auditor should also obtain an understanding of the control environment for environmental matters. For example, areas to be examined could include a governing body’s and its management’s attitude, awareness, and actions toward internal control.
3. If the auditor considers there is a risk of material misstatement of the financial statements, specific procedures would need to be designed and performed to address this risk.

**[Example to be updated]**

**Water and Wastewater Management - Austria**

The Austrian Court of Audit recently conducted a study of grants given by the federal ministry of agriculture, forestry, environment, and water management. The study included an examination of the organization and its financing of the system. Fundraising and distribution of money was seen as important - the more efficient the system, the more projects could be funded and the more potential environmental benefits could be achieved.

|  |
| --- |
| **Questions that might prompt possible dimensions of an environmental audit in terms of control environment and control procedures**  |
| What is management’s philosophy and operating style with respect to environmental control in general?Does the entity’s operating structure include assigning responsibility, including segregation of duties, to specified individuals for environmental control? Does the entity maintain an environmental information system, based on requirements by regulators or the entity’s own evaluation of environmental risk?Does the entity operate an environmental management system (EMS)?• This system may provide, for example, information about physical quantities of emissions and hazardous waste, environmental characteristics of the products and services, or the results of inspections or incidents.• Examples of recognized standards for an EMS are the international standard ISO 14001 and the European Commission’s Eco-management and Audit Scheme (EMAS).How are anomalies identified and reported to management?Has the entity (voluntarily) published an environmental performance report? If so, has it been verified by an independent third party?Are control procedures in place to identify and assess environmental risk, to monitor compliance with environmental laws and regulations, and to monitor possible changes in environmental legislation likely to have an impact on the entity?Is management aware of the existence and the potential impact on the entity’s financial reporting of for example:• any risk of groundwater liabilities arising as a result of contamination of soil, groundwater, or surface water;• any risk of liabilities arising as a result of air pollution; or• any unresolved complaints about environmental matters from employees or third parties?Does the entity have operating and control procedures for the disposal of waste and hazardous waste in compliance with legal regulations? |

## Audit Criteria

1. Audit criteria are the standards against which the actual performance of the entity in relation to financial and compliance activities can be assessed. Audit criteria should be relevant and free from bias on the part of the auditor or audited entity.
2. The purpose of the criteria for the **environmental aspects of a financial audit** is to enable the auditor to establish whether the reporting entity has appropriately recognized, valued and reported environmental costs, liabilities (including contingent liabilities), and assets.

Sources of audit criteria could include:

* Mandatory standards issued by an authoritative standard setting body.
* Standards issued by some other recognised body.
* International standards issued by a recognised body.
* Guidance issued by a relevant professional body.
* Academic literature.

[EXAMPLE]??

1. The purpose of the criteria for an **environmental compliance audit** is to enable the auditor to establish whether the entity has conducted the environmental activity in compliance with applicable obligations.
2. The term “obligation” for this purpose has its ordinary meaning of something with which the audited entity must comply. It may be a direct legal obligation or an obligation arising from a duty to comply with the policy of a superior executive authority.
3. Authoritative sources could, therefore, include:
* National laws - Acts of the legislature and any regulations, rules, orders etc. made under an Act and having the force of law.
* Supranational laws - such as legislation enacted by organs of the European Union.
* International agreements - such as treaties with other jurisdictions and United Nations Conventions.
* Binding standards (including techniques, procedures, and qualitative criteria).
* Contracts.
* Policy directives.
1. The criteria against which the subject matter is assessed should be agreed with the auditee, and identified in the audit report. In performing environmental financial and compliance audits, the criteria may differ greatly from audit to audit. Clear identification of the criteria in the report is, therefore, important so that the users can understand the basis for the audit work and conclusions.

## Perform substantive procedures

1. The auditor also obtains evidence to support the environmental disclosures made in the financial statements through enquiries of management - those responsible for preparing the financial statements and those responsible for environmental matters.
2. If the entity has an internal auditing function, which examines environmental aspects of the entity’s operations, the auditor should consider using that work if it can be relied on. In certain situations, an environmental expert may be involved in an outcome recognized or disclosed in the financial statements, for example, in quantifying the nature and extent of a contamination, considering alternative methods of site restoration, etc. In such cases, the auditor should consider the impact of the expert’s work on the financial statements and the professional competence and objectivity of the environmental expert.
3. Another aspect the auditor may consider is the use of any income that an entity may be responsible for collecting, such as funds collected under the “polluter pays” model. The auditor may examine the financial systems and controls around the collection of such funds, and also whether the funds are being used for their intended purposes.

|  |
| --- |
| **Questions that might prompt possible environmental audit issues in the area of governmental programmes or activities** |
| Does the government have any **programmes** designed to protect, restore, and manage the environment?Who are responsible for these programs?What are the objectives of the programs?Is the government involved in **funding** programmes that are designed to achieve environmental objectives?If so, how is eligibility for funding determined? What are the criteria for eligibility?Such programmes might include maintaining soils in croplands; providing irrigation for agriculture; protecting watersheds; supporting forestry; supporting agriculture; protecting water bodies; conserving bio-diversity; improving energy efficiency; preventing pollution; managing urban waste; or protecting and preserving cultural heritage, national parks, heritage buildings, or places of special cultural or scientific value.• What resources are the departments using to achieve the required outcomes?• Are the resources accurately accounted for and the results accurately reported?• What responsibilities does the SAI have with respect to the accounting and reporting of the performance of these programmes? |

# Reporting

1. Environmental and sustainability reports are on the one hand, tools for communicating with stakeholders and managing business reputation. On the other hand, this kind of reporting can be internally important for an organization to improve its risk management and save resources and money.
2. Environmental and sustainability reporting are first developed in private sector companies. Increasingly, organizations in the public sector are also making progress in developing these reports. The role of the auditor is to provide assurance that these reports adequately reflect the actual results, risks and other relevant issues.

***Governmental reporting on environmental issues***

1. Demand for public accountability of persons or entities managing public resources has increased with growing public consciousness. There has been a move away from a singular focus on financial risk toward giving attention to all major risks that will impact on the public. The management of all significant risks to a body’s fulfilment of its objectives has led to changes in corporate responsibilities and reporting.
2. Some governments report information on environmental performance within the financial statements or separately. In such cases, SAIs may further the accountability and reporting aspects of their audit role.
3. Entities that have an impact on the environment can be categorized into three groups:

• entities whose operations directly or indirectly affect the environment, whether positively or negatively - such as by rehabilitation or utilization and pollution;

• entities with powers to make or influence environmental policy and regulations - whether internationally, nationally, or locally; and

• entities with the power to monitor and control the environmental actions of others.[[11]](#footnote-11)

1. If key environmental departments or agencies are required to produce a statement of what they intend to achieve (a statement of service performance for environmental outputs or outcomes), SAIs could encourage governments to make such statements a part of the entity’s request for a budget. Each year the achievement of the previous year’s statements could be reviewed as part of the financial audit.
2. This could form that basis of an annual checkpoint for monitoring the progress toward the desired environmental outcomes. Each SAI should consider how appropriate this approach might be, bearing in mind its own mandate. Who is updating it?

**[Example to be updated]**

**Sea fisheries management and development - Republic of South Africa**

In 1997 the SAI of South Africa carried out an examination of the activities of the Department of Environmental Affairs and Tourism: Sea Fisheries Management and Development. The examination was to enhance the accountability process for environmental affairs by:

• auditing the financial statements;

• auditing compliance; and

• auditing performance.

The audit examined, amongst other things:

• the use and custody of assets;

• inefficient or ineffective management measures;

• matters which, in the public interest, should be brought to the attention of the legislature concerned; and

• non-compliance with legislation and other requirements that could influence the reasonable presentation in the financial statements.

The examination of the department’s financial and compliance activities were central to the environmental audit and allowed the SAI to, amongst other things, report that:

• financial reporting, performance reporting, and the implementation of environmental management systems have been impeded by a lack of legislation;

• capacity constraints impede the rendering of effective law enforcement services; and

• policy formulation and implementation were impeded by the unavailability of analytical environmental performance information, the absence of full cost accounting, and accurate information of the resource

## Sustainability reporting

1. Environmental reporting has developed since the 1980’s in various directions. On the one hand, there is a focus on social responsibility, which is manifested through corporate social responsibility reporting. On the other hand, there are holistic sustainability reports, which try to include environmental, social and economic concerns. Finally, there is a movement towards integrated reporting, which argues that all this information should be presented in one annual report along with financial information instead of publishing separate environmental or sustainability reports.
2. Assurance standards to verify sustainability reports have been developed in the private sector. However, SAIs’ objective in financial auditing is wider compared to the private sector. Public sector auditors look at more extensive accountabilities and what matters more is information on policy and policy effects, which are often presented in the form of key figures and performance indicators.

The following SAIs have developed and published guidelines on sustainability reporting in order to help public sector organisations to improve their environmental reporting and provide the basis for the auditors’ assessments.

The INTOSAI WGEA publication "Sustainability reporting: Concepts, Frameworks and the Role of Supreme Audit Institutions" explains the recent development related to sustainability reporting and discusses what it could mean for SAIs. For instance SAIs could provide best practices and guidance. Moreover, if sustainability reporting becomes more widespread in the public sector, the question of whether to provide some assurance of sustainability information seems inevitable.

As an example, the SAI of Australia has published better practice guidance in order to help public sector organisations to meet and improve their environmental performance and reporting. The guide focuses on six key operational areas: energy, ICT, waste, water, travel and property management. The guide provides practical implementation advice, case studies and checklists, in addition to suggested performance indicators.

As another example, in the UK, the Government has published guidelines on sustainability reporting for Central Government Organisations. Since the 2011-12 financial year onwards, it has been mandatory for UK and English organisations to include a sustainability report within their Annual Report. The minimum requirements include sustainability data as well as related expenditure on organisations' greenhouse gas emissions, waste minimisation and management, as well as use of finite resources. Organizations are also required to provide commentary on how they are making their procurement more sustainable, and where relevant, progress against their biodiversity targets. The UK National Audit Office (NAO) has recently performed a general assessment of sustainability reporting in UK central government. It found that some areas still needs improvement and that the Government needs to address the risk that Departments could inappropriately marginalise their sustainability reporting if annual reports are streamlined.

<http://www.environmental-auditing.org/LinkClick.aspx?fileticket=vM4hrHlBd0s%3d&tabid=128&mid=568>

<http://www.nao.org.uk/wp-content/uploads/2015/02/Sustainability-reporting-in-central-government-an-update.pdf>

**[Example to be updated]**

**Department of Trade and Industry, consolidated departmental resource accounts for 2002–03 United Kingdom**

The annual consolidated departmental resource accounts for the Department of Trade and Industry include the following disclosures:

• a provision to meet some of the costs of restoring the heavily contaminated land at a coke works - the minimum costs required to meet standard environmental standards;

• a provision, through an arrangement with the United Kingdom Atomic Energy Authority, to cover the costs of liabilities from programmes associated with, among other things, the decommissioning of radioactive plant and facilities; and

• provisions for health-related liabilities to cover damage to workers caused by exposure to environmental hazards such as coal mine dust and fumes, and prolonged use of vibratory tools.

1. International Auditing Practice Statement 1010: The Consideration of Environmental Matters in the Audit of Financial Statements, March 1998. [↑](#footnote-ref-1)
2. International Public Sector Accounting Standard IPSAS1: Presentation of Financial Statements issued by the International Federation of Accountants. *This version includes amendments resulting from IPSASs issued up to January 15. 2011.* [↑](#footnote-ref-2)
3. International Standard on Auditing ISA 200: Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing. [↑](#footnote-ref-3)
4. International Federation of Accountants, Public Sector Committee, Governmental Financial Reporting Accounting Issues and Practices, May 2000. [↑](#footnote-ref-4)
5. For example, ISA 37: Provisions, Contingent Liabilities and Contingent Assets provides general considerations that apply to the recognition and disclosure of provision and contingent losses, including those arising from environmental matters. Examples of environmental liabilities are also provided. [↑](#footnote-ref-5)
6. http://www.ifac.org/system/files/downloads/b007-2010-iaasb-handbook-iaps-1010.pdf [↑](#footnote-ref-6)
7. ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements. [↑](#footnote-ref-7)
8. ISA 310, paragraph 2. [↑](#footnote-ref-8)
9. § 6d of ISSAI 40; Appendix 6 § 2.2 of ISSAI 3000 [currently under review]. [↑](#footnote-ref-9)
10. Standards for an EMS have been issued by the International Organization for Standardisation ISO 14001: *Environmental Management System - Specification with Guidance for Use.* [↑](#footnote-ref-10)
11. INTOSAI, *Guidance on Conducting Audits of Activities with an Environmental Perspective, 2000.* [↑](#footnote-ref-11)