

# Environmental Audit and Regularity Auditing

International Organization of  
Supreme Audit Institutions -  
INTOSAI  
Working Group on Environmental  
Auditing - WGEA

## BACKGROUND

This article is a synopsis of the INTOSAI Working Group on Environmental Auditing (WGEA) paper, 'Environmental Audit and Regularity Auditing'<sup>1</sup> that is due to be presented for approval as a formal INTOSAI document at the INCOSAI meeting in Budapest, Hungary in October 2004.

The paper was developed in response to an issue that was raised at the 6th meeting of the WGEA held in Cape Town, South Africa (April 2000): that of the difficulties faced by auditors in addressing environmental issues within a regularity (financial and compliance) audit framework.

Accountants and auditors have traditionally not been associated with the conservation or environmental movement. However, as providers of information, reports, and assurance on which business and government decisions are frequently based, 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 analyze, 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.

The paper illustrates how an environmental audit focus can be brought to the financial and compliance audit activities of a SAI.

## TYPES OF AUDITS

Previously, in its paper, "Guidance on Conducting Audits of Activities with an Environmental Perspective"<sup>2</sup>, the Working Group on Environmental Auditing has identified three types of audits in which environmental issues can be addressed. These are audits of financial statements, compliance audits and performance audits.

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1. <http://www.environmental-auditing.org>

2. INTOSAI WGEA Guidance on Conducting Audits of Activities with an Environmental Perspective 2000.

## FINANCIAL STATEMENT AUDITS

During an audit of financial statements, environmental issues may include the following:

- 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.

## COMPLIANCE AUDITS

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. As stated above, financial statement audits may also include examination of compliance with accounting standards and financial regulations.

## PERFORMANCE AUDITS

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
- ensuring that environmental programmes are conducted in an economical, efficient and effective manner<sup>3</sup>.

Which of these different types of audits a SAI may use will depend primarily on the mandate under which the SAI operates.

## THE REGULARITY AUDIT

A regularity audit (defined by INTOSAI Auditing Standards<sup>4</sup>.) 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.

The standards acknowledges that there can be overlap between regularity and performance auditing, and in such cases classification of a particular audit will depend on the primary purpose of that audit.

## FINANCIAL AUDIT

Financial statements should 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 information useful for decision-making and demonstrate an entity's accountability of its resources<sup>5</sup>.

3. The INTOSAI WGEA Guidance on Conducting Audits of Activities with an Environmental Perspective 2000 describes in more detail the different types of performance audits that can be conducted (paragraph 210).

4. INTOSAI Auditing Standards, June 1992.

5. International Public Sector Accounting Standard IPSAS1: *Presentation of Financial Statements* issued by the International Federation of Accountants, May 2000.

Generally, financial statements of governments (or their constituent entities) have tended to avoid environmental issues. However, there is a realisation that there are costs, compliance, and performance issues associated with environmental policies and obligations that should be reflected in financial statements.

The International Auditing Practices Committee (IPAC) defines environmental matters in a financial audit as:

(a) “initiatives to prevent, abate or remedy damage to the environment or to deal with the conservation of renewable and non-renewable resources (such initiatives may be required by environmental laws and regulations or by contract, or they may be undertaken voluntarily);

(b) consequences of violating environmental laws and regulations;

(c) consequences of environmental damage done to others or to natural resources; and

(d) consequences of vicarious liability imposed by law (for example, liability for damages caused by previous owners)”<sup>6</sup>.

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 environmental 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.

## COMPLIANCE AUDIT

Compliance audits can examine an entities compliance with a range of matters. Firstly, they can examine an entities compliance with financial authorities and accounting practices (for example, legislative controls such as appropriations of the entities 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 of relevance in relation to the wider use of public funds.

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.
- Identify liabilities and risks.

The regularity audit therefore encompasses financial and compliance auditing, and the compliance aspect of a regularity audit may be in relation to compliance with accounting standards and/or compliance with relevant environmental laws and treaties.

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6. International Auditing Practice Statement 1010: The Consideration of Environmental Matters in the Audit of Financial Statements, March 1998.

## WHAT CAN A REGULARITY AUDITOR DO? <sup>7</sup>

### OBTAIN KNOWLEDGE OF ENVIRONMENTAL MATTERS

In all audits, a sufficient knowledge of the business 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 (ISA 310, paragraph 2).

The auditor is not expected to know more than management or the environmental experts.

The regularity auditor should consider the industry in which the entity operates, as it could indicate the possible existence of environmental liabilities and contingencies. Certain industries 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.

Assess inherent risk, internal control systems, and control environment

Having acquired a sufficient knowledge of the business, the auditor assesses the risk of material misstatement in the financial statements. This would include the risk of misstatement due to environmental matters, namely environmental risk.

Examples of environmental risk include:

- compliance costs arising from legislation; and
- impact of non-compliance with environmental laws and regulations.

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)<sup>8</sup>.

The auditor should also obtain an understanding of the control environment for environmental matters. For example, areas to examine could include a governing body's and its management's attitude, awareness, and actions toward internal control.

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 ensure that there is no material misstatement.

### CONSIDER LAWS AND REGULATIONS

When planning and performing an audit, a regularity auditor evaluates compliance with applicable laws and regulations, where non-compliance may materially affect the financial statements. However, an audit cannot be expected to detect non-compliance with all laws and regulations<sup>9</sup>.

The regularity auditor obtains a general 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.

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7. 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. The WGEA paper 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.

8. Standards for an EMS have been issued by the International Organization for Standardisation ISO 14001: Environmental Management System—Specification with Guidance for Use.

9. ISA 250: Consideration of Laws and Regulations in an Audit of Financial Statements.

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 training, experience and understanding of the entity and industry to recognize non-compliance issues and seek expert advice.

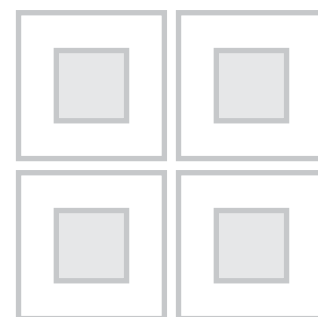
#### PERFORM SUBSTANTIVE PROCEDURES

The regularity 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.

If the entity has an internal auditing function, which examines environmental aspects of the entity's operations, the auditor should consider using that work. In certain situations, an environmental expert may be involved in an outcome that is recognized or disclosed in the financial statements, for example, in quantifying the nature and extent of a contamination, or in 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.

Another aspect the regularity 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 the purposes it was intended.

***Environmental reports have been developed as a method for companies to communicate their environmental performance and impact to stakeholders; they can be seen as a new and important aspect of corporate governance. Such reports might include an organizational profile, an environmental policy statement, details of targets and achievements, and details of performance and compliance.***



## REPORTING

### SERVICE PERFORMANCE REPORTING

Some governments either report information on service performance in financial statements or separately. In such cases, SAIs may further the accountability and reporting aspects of their regularity audit role.

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.
- Entities with the power to monitor and control the environmental actions of others<sup>10</sup>.

“Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for the correctness and sufficiency of the form and content of the financial reports and other information”<sup>11</sup>.

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.

### OTHER FORMS OF REPORTING

Organizations in the public sector are making progress in developing corporate governance and arrangements for risk management. 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 fulfillment of its objectives has led to changes in corporate responsibilities and reporting.

Environmental reports have been developed as a method for companies to communicate their environmental performance and impact to stakeholders; they can be seen as a new and important aspect of corporate governance. Such reports might include an organizational profile, an environmental policy statement, details of targets and achievements, and details of performance and compliance. ■

10. INTOSAI Guidance on Conducting Audits of Activities with an Environmental Perspective, 2000.

11. INTOSAI Auditing Standards, Revised Edition 1992, paragraphs 23-24.

## CONCLUSION

The environmental problems of the world will not be solved overnight nor will they be solved solely by the actions of SAIs. However, much trust is placed in the role of the SAIs and they can be part of the solution.

A supreme audit institution can undertake an audit with an environmental focus using a regularity (financial and compliance) mandate. It is not necessary to have a performance audit mandate to conduct an audit with an environmental focus. A SAI may feel that their greatest skills and experience lie in the audit of financial and compliance issues. It would make sense for them to use this experience in an environmental audit.

The role of a SAI is to respond to the expectations of citizens by providing independent, credible, and objective verification of the information provided by government agencies with respect to their activities and their impact on the environment.

The audit of financial statements enables 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. In this context the audit of financial statements requires the auditor to consider environmental matters as part of the regularity audit.

In addition, auditors need to be aware of ongoing developments—such as recognizing environmental assets. They should seek out opportunities to encourage their clients to adopt regimes that may be considered good practice but are not currently mandatory—for instance, the production of environmental reports. As standards—in both financial reporting and corporate governance—move toward fuller reporting and disclosure of environmental, social, and ethical reporting, auditors will need to reappraise their approach. ■

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