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ENVIRONMENTAL ISSUES IN THE AUDIT OF FINANCIAL STATEMENTS

OVERVIEW

The importance of the environment is increasingly recognised. Environmental issues often have implications for business and cannot be ignored by auditors. Auditors need a general awareness of the risk that environmental issues may have an impact on the financial statements.

At present, there is little guidance relating to the auditing implications of environmentally-related issues. This discussion paper is intended to stimulate thought on the subject as a step towards enhancing auditors’ knowledge of the possible impact of environmental issues. The paper seeks to provide guidance of a practical nature but is not intended to create the impression that an audit in accordance with Statements of Auditing Standards requires a high level of knowledge relating to environmental issues. For the majority of entities, environmental matters are not likely to have any material impact on their financial statements.

It is not practicable to quantify how far an auditor should go in searching for information to understand the business but we hope that the issues discussed in this paper would help the auditor to decide what information is needed.

Whist much of the publicity regarding environmental issues has involved large, often multinational, companies, auditors of small and medium-sized entities should not assume that such businesses are immune to environmental problems that may have an impact on the financial statements.

Key issues

The paper discusses a number of issues that the auditor may wish to consider, depending on the nature of the entity. Some of the key questions addressed are:

• How should an auditor decide whether environmental issues may be significant to the entity’s financial statements?

• Where environmental matters may be significant, how should the auditor assess the risk of a consequent material misstatement in the financial statements?

• Should an auditor expect an entity to operate controls over environmental risks and to what extent should the auditor evaluate such controls?

• Should the auditor check whether the entity is complying with environmental laws and regulations and what action is appropriate if the auditor becomes aware of non-compliance?

• Are there any particular difficulties in recognising and measuring the financial effects of environmental matters and how should the auditor deal with such problems?
Conclusions

In broad terms, the conclusions can be summarised as follows:

(i) Environmental matters will be important for some entities and auditors should have a general awareness of the impact that such matters may have on the financial statements.

(ii) The significance of environmental matters to the financial statements normally depends on the nature and location of an entity’s business and the environmental laws and regulations under which it operates.

(iii) The auditor does not need a specific knowledge of environmental matters but should obtain sufficient knowledge of the business to understand the issues that may have a significant effect on the financial statements.

(iv) The auditor requires information from management relating to environmental risk and discussion with management is likely to help the auditor to identify significant environmental issues.

(v) In view of the uncertainties in recognising and measuring environmental liabilities, typically relating to the timing of clean up, the technology available or possible new legislation, the auditor needs to exercise particular care in assessing the risk of a material misstatement or omission in the financial statements.

(vi) Where environmental matters may be a significant source of risk, an internal control system would not be effective unless it covered items giving rise to environmental risk.

(vii) Whilst management is responsible for all internal controls to safeguard the shareholders’ investment and the company’s assets, the auditor is only concerned with those environmental controls that are considered relevant to the audit of the financial statements.

(viii) Auditors carry out their work recognising that non-compliance with laws or regulations may materially affect the financial statements. In view of the growing body of environment law, the auditor needs to obtain a general understanding of these laws and regulations relevant to the business, including those that are specific to an industry sector.

(ix) There are a number of difficulties in recognising and measuring the financial effects of environmental matters in the financial statements, all of which may have implications for the auditor.

(x) Where management engages an expert to provide technical advice to assist in developing estimates and disclosures in the financial statements relating to environmental matters, the auditor should consider the adequacy of such work, as well as the expert’s competence and objectivity.
Invitation to comment

We would welcome comments on the discussion paper, both from audit practitioners and from those who use financial statements. In addition to commenting on the text below each of the questions in bold type, it would be helpful to have views on some or all of the following issues:

(a) Are there any areas in which you consider additional education and training is required to enable an auditor to address the issues raised in the discussion paper more effectively?

(b) Do you agree that the implications of environmental issues in relation to audit reports are no different in principle to those arising from other issues? Are there any unique features that need to be considered?

(c) Do you consider that the appendices are helpful? Would any improvements to the appendices be appropriate?

(d) Are there any other matters that are not addressed in the discussion paper on which guidance would be helpful?

(e) In what form would you prefer any subsequent guidance to be issued, given that the Auditing Practices Board (APB) is considering what guidance, if any, should be issued?

Comments on the discussion paper should be addressed to:

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Comments should be received by 31 May 2000 and will be assumed to be on public record unless the respondent specifically requests confidentiality. Copies of the comments received will be made available to the ICAEW Audit Faculty and to the APB.
INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (ICAEW) believes that environmental issues are important. Whilst they need to be considered in the context of other matters concerning compliance with laws and regulations that may be relevant to the preparation and audit of financial statements, auditors should have a general awareness of the risk that environmental issues may have an impact on the financial statements. We believe that non-mandatory guidance of a practical nature will encourage that awareness.

2. This discussion paper is intended as a stepping stone in the development of more specific guidance, recognising that the reporting and auditing of financial information relating to the environment is an evolving field. The discussion paper has been developed by a working party set up by the ICAEW’s Environment Steering Group and is issued jointly with the Audit Faculty. The names of members of the working party are listed in Appendix 1.

3. In its 1992 research report, the ICAEW Environmental Research Group noted that the auditor’s responsibilities already extend to consideration of the impact of environmental issues on financial statements in relation to:

   • provisions, e.g. for site restoration costs;
   • contingent liabilities, e.g. arising from pending legal action;
   • asset values, e.g. where stocks of goods, or the fixed assets used in producing them, are subject to environmental concern;
   • accounting for capital or revenue expenditure on cleaning up the production process or to meet legal and other standards;
   • product redesign costs; and
   • product viability/going concern considerations, e.g. where new regulations impose more stringent criteria for emissions.

4. A 1996 research report concluded (inter alia) that:

   • Awareness of the potential financial effects of environmental issues is unevenly distributed amongst auditors and should be raised.
   • Auditors, particularly those in small firms, risk under-emphasising environmental issues and the financial consequences.

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2 'The financial auditor and the environment' by David Collison, Rob Gray and John Innes, published by the ICAEW Research Board (1996).
• Professional bodies need to develop non-mandatory guidance for their members on environmental issues.

• The UK auditing and accountancy profession should monitor the impact of environmental issues on financial statements and seek to raise the awareness and expertise of its members by issuing non-mandatory guidance as a precursor to issuing a statement of auditing standards.

5. Guidance on good practice in environmental reporting was published by the Advisory Committee on Business and the Environment (ACBE) in February 1997. This noted that environmental liabilities and costs reported in the accounts are subject to financial audit. The guidance also observed that a flexible approach to environmental information is required. There is little detailed guidance relating directly to the financial reporting of environmentally-related issues and even less on the auditing implications.

6. This discussion paper addresses the relevance of environmental issues to the audit of financial statements conducted in accordance with UK Auditing Standards. The implications of environmental issues in relation to audit reports are considered to be no different in principle to those arising from other issues and are consequently excluded. The paper does not deal with health and safety issues or matters concerned with environmental health. It also does not address the issues that may arise in providing assurance on environmental reports, on which a discussion paper was issued by the Fédération des Experts Comptables Européens (FEE) in October 1999.

7. In March 1998, the International Federation of Accountants (IFAC) issued an international auditing practice statement developed by the International Auditing Practices Committee (IAPC) on ‘The consideration of environmental matters in the audit of financial statements’ (the IAPC statement). This referred to the increasing significance of environmental matters and the fact that such matters may have a material impact on an entity’s financial statements.

8. The IAPC statement was preceded in June 1997 by an exposure draft on the same subject. In its submission on the exposure draft, the Auditing Practices Board (APB):

• welcomed IAPC’s decision to develop guidance on environmental matters that are widely recognised as having an increasing impact on the financial statements of certain types of entity;

• observed that the guidance in the draft statement may be helpful to an auditor when the environmental issues facing the entity are complex and there is a significant risk of a material impact on the financial statements, but noted that such circumstances are relatively infrequent; and

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3 ‘Environmental Reporting and the Financial Sector: An approach to Good Practice’ published by the Advisory Committee on Business and the Environment (February 1997)
• warned that, in addressing any new or evolving area of practice, particular care must be taken to ensure that guidance does not inadvertently increase auditors’ responsibilities or mislead users of audited financial statements as to the level of assurance that auditors can provide.

9. The APB has indicated that it is considering what guidance, if any, it believes needs to be issued in the UK and Republic of Ireland in relation to environmental issues in the audit of financial statements. In this context, the APB welcomes the ICAEW’s discussion paper and encourages members of the auditing profession and others to respond to the issues raised in it.

10. The discussion paper poses a number of issues relating to environmental matters that the auditor may wish to consider, depending on the nature of the entity whose financial statements are subject to audit. These issues are dealt with in the form of questions followed by discursive material. The text is not intended to provide a prescriptive answer and views on the issues, particularly as regards whether the auditor is competent to take the action suggested, would be welcome.

11. We acknowledge that most auditors have a limited knowledge of environmental issues and their potential impact on financial statements and that progress in this direction will take time. There is a need for more attention to this topic within the education and training syllabus. Auditors will also need to consider the implications for staff training, with particular regard to the proposed revision of SAS 240 ‘Quality control for audit work’. In the meantime, this discussion paper is intended to enhance auditors’ knowledge about such issues without increasing their responsibilities.

12. Some audit firms find the use of brief checklists dealing with environmental matters useful for audit planning purposes. Depending on the nature of the business, these might address industry-specific issues as well as more general topics. Appendices 2 and 3 provide examples of illustrative questions that an auditor may wish to consider when obtaining a knowledge of the business and substantive audit procedures that an auditor may perform.
ENVIRONMENTAL ISSUES IN THE AUDIT OF FINANCIAL STATEMENTS

KNOWLEDGE OF THE BUSINESS

Q1 How should an auditor decide whether environmental issues may be significant to the entity’s financial statements?

1.1 The significance of environmental matters to the financial statements normally depends on the nature of an entity’s business. Whilst certain industries, by their nature, tend to be exposed to significant environmental risk, potential impact on the financial statements may arise from:

(a) the application of environmental laws and regulations (dealt with in more detail in section 6 below);

(b) the operation of processes that:
   – may have caused, or continue to cause, pollution of soil, groundwater, surface water or air;
   – use hazardous substances or generate hazardous waste; or
   – may potentially have an adverse effect on customers, employees or neighbouring sites;

(c) the holding of an interest in land and buildings that have been contaminated by previous occupants; or

(d) dependence on a major customer or segment whose business is threatened by environmental pressures.

1.2 The auditor will normally have a reasonably good level of understanding of the nature of a company’s business but needs to be alert to the possibility of any harmful environmental impacts. Auditors do not have a specific knowledge of environmental matters, which may often involve considerable complexity. In planning the audit, the auditor need not undertake extensive research but should obtain sufficient knowledge of the business to understand the events, transactions and practices that may have a significant effect on the financial statements or the audit (SAS 210 ‘Knowledge of the business’). The information described in paragraph 3.1 below may be relevant as part of the auditor’s understanding of the business. If the entity produces a separate environmental report, reading the report may also assist the auditor in obtaining a knowledge of the business.

1.3 Some entities, for example those in the extractive industries, chemical manufacturers or waste management companies, may incur environmental obligations as a direct result of their core businesses. For such entities, compliance with environmental laws and regulations is often central to the business.

4 ‘Statement of Auditing Standards’, issued by the Auditing Practices Board
1.4 Other entities may be affected by market issues and, in particular, a product’s compliance with environmental legislation, customer perceptions of a product’s environmental performance and the impact of environmental pressures on suppliers.

1.5 From the environmental viewpoint, the location of an entity is important. This largely determines the regulatory bodies responsible for controlling environmental impacts at the site or sites. It may also raise questions concerning previous activities at the same location that may have caused environmental pollution. The “polluter pays” principle might suggest that the previous occupant is responsible for any necessary clean-up costs but, in practice, this may be very difficult to enforce.

1.6 The value of a company’s property could be affected by environmental contamination or contamination of a neighbouring site. This could result from the cost of clean-up operations, or a reduction in realisable value because of the “stigma” effect arising from the adjacent property.

1.7 Regardless of legal requirements, constructive obligations may stem from voluntary initiatives, for example an entity may have identified contamination of land and, although under no legal obligation, it may have decided (and announced its intention) to remedy the contamination, because of concern for its long-term reputation and its relationship with the community. The announcement of intention would not automatically result in a constructive obligation and the circumstances would need to be such that the entity cannot reasonably avoid the future expenditure.

1.8 The size of an entity has no direct bearing on whether environmental matters are likely to be significant to its operations, in that small operations are, in principle, as likely to cause environmental damage as large operations.

1.9 Examples of illustrative questions that an auditor may wish to consider when obtaining a knowledge of the business are set out in Appendix 2 to this discussion paper.

Q2 What additional steps are necessary where environmental matters are potentially significant to the financial statements? What level of understanding of such matters should the auditor have?

2.1 The additional steps that are necessary where environmental matters are potentially significant will depend on the auditor’s assessment of the resulting risk to the reliability of the financial statements. In making this assessment, evaluation of the relevant factors requires professional judgement by the auditor.

2.2 The auditor may consider there is a need to include specific procedures to obtain sufficient audit evidence that the financial statements are not materially misstated. In determining the nature and timing of procedures to reduce the risk of material misstatement, the auditor assesses the level of risk and obtains evidence from management responsible for financial and environmental matters. Information
obtained from such assertions may need to be corroborated by evidence from other internal or external sources.

2.3 Technical advice may need to be sought from specialists, such as environmental experts, engineers or lawyers. This may be derived from work carried out by a specialist engaged by management or by the auditor. The use of specialists is dealt with in SAS 520 ‘Using the work of an expert’ (March 1995) and is discussed in section 12 below.

2.4 In seeking audit evidence in relation to environmental matters, there is often a high level of uncertainty. The auditor therefore has to use professional judgement in deciding whether the audit procedures provide sufficient persuasive evidence that the financial statements are not materially misstated.

RISK ASSESSMENT AND INTERNAL CONTROL

Q3 What benefits would be gained by discussing environmental matters with management?

3.1 The auditor’s understanding of a particular business is usually more limited than that of management and the auditor requires information from management relating to environmental risk. Discussion with management is therefore likely to help the auditor to identify significant environmental issues. Depending on the nature of the business, such a discussion might be based on some of the issues listed in Appendix 2 and could provide information about:

- the environmental impacts of previous and existing operations;
- possible future changes in activities or the processes involved;
- existing and proposed regulations and their effect on the business;
- fines or penalties incurred; and
- capital projects with a significant environmental element.

Some of these issues may have an impact on the financial statements. The information may, therefore, be helpful to the auditor, even if relevance to the audit of the financial statements is not immediately apparent.

3.2 Although not part of the audit, such discussions may also be of benefit to management, for example the auditor may have knowledge or experience of environmental matters and their financial significance that would be relevant to the business.
Q4 Where environmental matters may be significant, how should the auditor assess the risk of a consequent material misstatement in the financial statements?

4.1 Preparation of the financial statements involves a judgement of the most likely environmental outcome in such circumstances, its timing and financial impact. This judgement is exercised by the directors, the auditor’s role being the assessment of the risk of a material misstatement or omission.

4.2 In the case of environmental liabilities, their existence, timing and measurement often involve uncertainty. In assessing such a liability, the directors consider whether there is a legal obligation, or whether an entity’s past practice or a public statement by the entity indicates that a constructive obligation exists. There may be uncertainty relating to a proposed change in the law still to be enacted, as well as the technology available for any clean-up that will be necessary. In the extremely rare case where a liability exists but no reliable estimate can be made, a contingent liability is disclosed.

4.3 An event that does not give rise to an obligation immediately may do so at a later date because of changes in the law. The effect of possible new environmental legislation is (only) taken into consideration when the legislation is virtually certain to be enacted.

4.4 FRS 12 refers to the specific example of an entity for which the cost of cleaning up a site at the end of its life is expected to be reduced by future changes in technology. The standard states that the amount of the provision to be recognised should reflect the reasonable expectation of technically qualified, objective observers, taking account of all available evidence as to the technology that will be available at the time of the clean-up. The standard emphasises that the development of completely new technology should not be anticipated unless supported by sufficient objective evidence.

4.5 In the case of a company that owns contaminated land but has no present or constructive obligation for clean-up and thus no outflow of resources is probable, FRS12 would prohibit the recognition of a provision. The asset would nevertheless be reviewed for impairment. Unless the possibility of a transfer of economic benefits to meet the cost of clean-up is remote, the standard may require disclosure as a contingent liability.

4.6 FRS12 includes an appendix illustrating its application to various recognition issues. In particular, examples 2A and 2B are concerned with the accounting treatment of contaminated land and example 6 considers whether an obligation should be recognised in the case of new legislation requiring the fitting of smoke filters.

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4.7 The auditor reviews the process adopted by management in making accounting estimates, taking into account completeness of available information, use of competent advice, the degree of prudence exercised and the approach adopted for dealing with inherent uncertainty. As stated in SAS 420 ‘Audit of accounting estimates’, auditors should adopt one or a combination of the following approaches in the audit of an accounting estimate:

(a) review and test the process used by management or the directors to develop the estimate;

(b) use an independent estimate for comparison with that prepared by management or the directors;

(c) review subsequent events. (SAS 420.3)

In the light of the auditor’s understanding of the business, the auditor assesses the process to ensure that there is no material misstatement in the financial statements.

Q5 Should an auditor expect an entity to operate controls over environmental risks and to what extent should the auditor evaluate such controls?

5.1 Internal control is one of the principal elements in the management of risk and a sound system of internal control depends on a thorough and regular evaluation of the nature and extent of the risks to which an entity is exposed. Environmental matters may be a significant source of risk. Where this is the case, an internal control system would not be effective unless it covered items giving rise to environmental risk. Under the Turnbull guidance, management is responsible for reviewing all internal controls. By contrast, the scope of the auditor’s review is narrower and would normally be interpreted as focusing primarily on internal financial controls.

5.2 SAS 300 ‘Accounting and internal control systems and audit risk assessments’ (March 1995) states that auditors should obtain an understanding of the internal control system sufficient to plan the audit and develop an effective audit approach. An auditor uses professional judgement to assess the risk of misstatement or omission of an amount in the financial statements and to design audit procedures to reduce this risk to an acceptably low level (SAS 300.1). The audit approach is based on a number of factors, including the auditor’s understanding of the controls in operations. Amongst other matters, internal controls are concerned with the accuracy and completeness of records, the safeguarding of assets and the prompt recording of events relevant to the financial statements. Where environmental matters represent a significant risk, they may fall within the ambit of the internal control system.

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6 Principle D2 of the Combined Code of the Committee on Corporate Governance states that “The board should maintain a sound system of internal control to safeguard the shareholders’ investment and the company’s assets”. The Code also states that the directors should, at least annually, review the effectiveness of the internal control system and that the review should cover all controls, including financial, operational and risk management. The publication ‘Internal Control: Guidance for Directors on the Combined Code’, issued by the ICAEW Internal Control Working Party (the Turnbull working party) in September 1999 provides guidance to assist listed companies in implementing these requirements.
5.3 Many internal controls relevant to large entities are not practical in a small business. Recording and accounting procedures may be performed by those who have both operating and custodial duties; for example, recording of waste products and effluents may be the responsibility of the manager in charge of production. Consequently, the auditor may not be able to rely on the segregation of duties to provide the necessary control.

5.4 The IAPC statement gives the following examples of environmental risk at financial statement level:

- the risk of compliance costs arising from legislation or from contractual requirements;
- the risk of non-compliance with environmental laws and regulations; and
- the possible effects of specific environmental requirements of customers and their possible reactions to the entity’s environmental conduct.

The auditor considers any significant environmental risk in relation to the amounts involved.

5.5 Auditors should bear in mind that the existence of an environment information system or an environment management system does not necessarily ensure that there is no risk of material misstatement in the financial statements.

5.6 It is management’s responsibility to design and operate internal controls to assist in achieving, as far as practicable, orderly and efficient conduct of the business, including any environmental aspects. The auditor is only concerned with those environmental controls that are considered relevant to the audit of the financial statements. In practice, the way in which management achieves control over environmental matters varies:

- entities with low exposure to environmental risk, or smaller entities, will probably monitor and control environmental matters as part of their normal accounting and internal control systems;
- some entities that operate in industries with a high exposure to environmental risk may design and operate a separate internal control sub-system. Such a system may be designed to conform with standards for environmental management systems (EMS) issued by the International Organization for Standardization, described in section 7 below;
- other entities design and operate all their controls within an integrated control system, encompassing policies and procedures related to accounting, environmental and other matters (e.g. quality, health and safety).
some companies may have obtained registration for the environmental controls at specific sites where they operate, under the European Commission’s Eco-Management and Audit Scheme (EMAS).

ENVIRONMENTAL LAWS AND REGULATIONS

Q6 Should the auditor check whether the entity is complying with relevant environmental laws and regulations? What action, if any, is appropriate if the auditor becomes aware of non-compliance with environmental legislation?

6.1 Issues arising from the application of environmental laws and regulations, or changes thereto, could have wide-ranging impacts on financial statements and hence on the audit. Examples include:

- An impairment of assets - inventory, plant and equipment, or land and buildings - and the consequent need to write down their carrying value.

- Failure to comply with existing requirements (in areas such as emissions or waste disposal) or changes to legislation, may require accrual in respect of fines or other corrective, compensatory or legal costs.

- Where the expense relating to environmental matters cannot be reliably estimated, an entity may need to disclose the existence of a contingent liability in the notes to the financial statements.

- In extreme situations, non-compliance with certain environmental laws and regulations may affect the continuance of an entity as a going concern and, consequently, may affect disclosures and the basis of preparation of the financial statements.

6.2 The auditor’s duties with regard to environmental laws and regulations are the same as those with regard to any other laws and regulations. SAS 120 ‘Consideration of law and regulations’ (January 1995) requires auditors to perform their work recognising that non-compliance by the entity with law or regulations may materially affect the financial statements (SAS 120.1).

6.3 SAS 120 requires the auditor to perform certain limited procedures to help identify possible or actual instances of non-compliance with those laws and regulations that provide a legal framework within which the entity conducts its business and which are central to the entity’s ability to conduct its business and hence to its financial statements (SAS 120.3). For some businesses, such as those described in paragraph 1.3, non-compliance with environmental obligations would often be central to the core operations. For other businesses, however, it should not be assumed that non-compliance with environmental laws and regulations will necessarily fall into this category. Indeed, this would probably only apply in the rare circumstances where irregularities could result in closure of the business, either because of withdrawal of an operating licence or because a fine would be so large as to be “life threatening”.

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6.4 SAS 120 clarifies that the auditor needs to obtain a general understanding of those laws and regulations relevant to the business, including a general understanding of those that are specific to an industry sector. The standard suggests that an example of an industry-specific regulation might comprise, in the case of a waste disposal company, the terms of licences held by the company under which it is allowed to dispose of hazardous waste.

6.5 A technical release issued by the Audit Faculty in April 1997 ‘Consideration of law and regulations : Guidance for auditors’ (AUDIT 2/97) sets out to help auditors by taking stock of experience in applying SAS 120, illustrated in a number of case studies. Although none of the case studies are specifically concerned with environmental issues, the technical release contains valuable guidance to help auditors understand what laws and regulations are likely to be central to the circumstances.

6.6 Procedures on discovery of possible non-compliance with laws and regulations, including the auditor’s responsibility for reporting to management, to addressees of the audit report or to third parties, are dealt with in SAS 120. Paragraphs 59 – 61 of SAS 120 provide guidance where non-compliance does not give rise to a statutory duty to report but reporting of the matter may be in the public interest.

6.7 In broad terms, management is responsible for ensuring compliance with environmental requirements, such as:

- laws and regulations that impose liability for environmental pollution arising from past events, including damage caused from previous occupancy;
- pollution prevention and control laws, directed towards identifying and regulating sources of pollution, reducing emissions and discharges; and
- environmental licences specifying operating conditions such as maximum emission levels.

Changes in environmental legislation could have significant consequences for the operations of an entity and could result in liabilities relating to past events that were not previously governed by legislation.

6.8 The past ten years have witnessed the proliferation of new environmental laws, regulations and directives, both at the UK and European level. This discussion paper does not, at this stage, attempt to summarise relevant UK environmental legislation as this would be likely to become outdated relatively quickly. However, to assist auditors, a brief indication of some of the principal legal instruments is set out in Appendix 4.

6.9 The main environmental regulator in England and Wales is the Environment Agency, established by the Environment Act 1995. The equivalent body in Scotland is the Scottish Environment Protection Agency. The Environment Agency is responsible for the licensing of discharges to watercourse (under the Water Resources Act 1991), management of waste sites (Environmental Protection Act
1990) and, with local authorities, regulating Integrated Pollution Prevention and Control. Environmental control is also exercised by planning authorities under the Town & Country Planning Act 1990 and by local authorities for certain industrial processes, statutory nuisance and contaminated land under the Environmental Protection Act 1990, as amended by the Environment Act 1995.

AUDIT PROCEDURES

Q7 To what extent should the auditor have regard to environmental standards such as those issued by the International Organization for Standardization (ISO) in particular ISO 14011 “Guidelines for environmental auditing”?

7.1 The International Organization for Standardization (ISO) has published three standards concerned with environmental auditing:

ISO 14010 Guidelines for environmental auditing
- General principles

ISO 14011 Guidelines for environmental auditing
- Audit procedures
- Auditing of environmental management systems

ISO 14012 Guidelines for environmental auditing
- Qualification criteria for environmental auditors

In the UK, similar standards have been published by the British Standards Institution (BSi). The standards are primarily designed for those conducting an environmental audit or the review of an environment management system (EMS) on the instructions of a client and are not relevant to the audit of financial statements under the Companies Act.

7.2 An environmental audit is defined as the systematic, documented verification process of objectively obtaining and evaluating audit evidence to determine whether specified environmental activities, events, conditions, management systems, or information about these matters, conform with audit criteria, and communicating the results of this process to the client. The financial auditor may need to consider the findings if an environmental audit of this nature has been carried out.

7.3 ISO 14011 sets out audit procedures for the planning and conduct of an audit of an environmental management system. Where management operates an EMS that has been audited under ISO 14011, the financial auditor may find it helpful to review the environmental audit findings in order to consider whether any reported control weaknesses would increase the risk of material misstatement in the financial statements.

7.4 ISO 14012 provides guidance on qualification criteria for internal and external environmental auditors and is not relevant to auditors of financial statements. However, in the event of a financial auditor reviewing the work of an environmental auditor, it could provide a preliminary reference point.
Q8 Are there any particular difficulties in recognising and measuring the financial effects of environmental matters? How should the auditor deal with such problems? Are materiality criteria different from those concerning other issues?

8.1. Particular difficulties may arise in recognising and measuring environmental liabilities and environmentally impaired assets. Problems may also arise in quantifying environmental costs, in deciding whether environmental expenditure should be capitalised, and in dealing with the accounting treatment and possible disclosure of environmental taxes, fines and penalties. These issues are discussed in the paragraphs that follow.

8.2 In many businesses, management may not be aware of circumstances that may have an environmental impact, with the result that recognition and measurement issues are not discussed. For instance, wide-ranging implications of new laws, such as the Contaminated Land Regulations that are to be implemented in April 2000, may not be understood. Such situations may create difficulties for the auditor and it is not the auditor’s role to adopt a management stance.

8.3 Environmental liabilities and costs are rarely disclosed separately. Where separate disclosure is made, the way in which such costs are identified should be explained, to ensure that comparisons between enterprises do not result in misleading conclusions. In the ICAEW paper ‘Environmental issues in financial reporting’ published in 1996, it was argued that, if an enterprise discloses environmental costs, the figure should not be an allocation of total costs but should be confined to those costs which relate “wholly and exclusively” to preventing, reducing or repairing damage to the environment. Whichever approach is adopted, any figure that is disclosed should be supported by a description of the basis used.

8.4 There are a number of difficulties in recognising and measuring the financial effects of environmental matters in financial statements, all of which have implications for the auditor, for example:

- There is often a considerable delay between the activity that causes an environmental issue and its identification by the entity or the regulators.

- Accounting estimates may not have an established historical pattern or may have wide ranges of reasonableness because of the number and nature of assumptions underlying the determination of these estimates.

- Environmental laws or regulations are evolving and interpretation may be difficult or ambiguous. Consultation with an expert may be necessary to assess the impact of these laws and regulations on the valuation of certain assets (for example, assets that contain asbestos). Making a reasonable estimate of liabilities for known obligations may also be difficult.

- Liabilities may arise other than as a result of legal or contractual obligations.
Consequently, the use of professional judgement by auditors may become even more important. As the IAPC statement emphasises, most of the audit evidence available is persuasive rather than conclusive. Auditors therefore need to use professional judgement in determining whether the planned substantive audit procedures, either individually or in combination, are appropriate.

8.5. In principle, materiality criteria applicable to environmental information are no different from those applicable to other information, i.e. that information is material if it could influence users’ decisions taken on the basis of the financial statements. In December 1996, the ICAEW issued a statement (TECH 32/96) ‘The interpretations of materiality in financial reporting’, which provides guidance for preparers, identifying the main determinants of materiality of an item as its size, its nature and its potential impact. Guidance for auditors is provided by SAS 220 ‘Materiality and the audit’.

8.6. Application of the materiality concept to an environmental matter may be more complex than for other items because of its nature and circumstances as well as its scale. For example, the carrying capacity of the receiving environment will be a factor in considering the materiality of a discharge of substances resulting from the reporting entity’s activities. It may be impossible to use a purely quantitative basis to decide whether an item is material, because the emission of a small amount of a toxic substance (for example, dioxin or mercury) can be material to the receiving environment. Where legal thresholds for emissions are exceeded, this may not necessarily be considered material in terms of the effect on the financial statements, particularly in the case of the first offence. Further guidance may be found in SAS 120 and AUDIT 2/97 (see paragraph 6.5 above).

Q9 Should the auditor review the accounting treatment adopted for significant environmental matters, such as the capitalisation of environmental costs or the recognition of environmental impairment?

9.1 SAS 470 ‘Overall review of financial statements’ (March 1995) requires that auditors should consider whether the information presented in the financial statements is in accordance with statutory requirements and the accounting policies employed are in accordance with accounting standards, properly disclosed, consistently applied and appropriate to the entity (SAS 470.2).

9.2 There are no statutory requirements relating specifically to the presentation in financial statements of information about environmental matters. The accounting standards that are of most relevance are FRS 12 ‘Provisions, contingent liabilities and contingent assets’ and FRS 11 ‘Impairment of fixed assets and goodwill’. These standards provide guidance of a general nature. There are also some examples of the way in which relevant accounting principles are applied to environmental issues.

9.3 In broad terms, as in the case of other items, expenditure incurred partly or mainly for environmental reasons may be capitalised if the expenditure is expected to result in future economic benefits to the enterprise. There is some uncertainty as to whether an increase in economic benefits, rather than continued economic benefits,
is required to meet the criteria for capitalisation. Depending on the circumstances, expenditure to mitigate future environmental damage, or to avoid closure where new laws would require an enterprise to curtail its operations, should almost certainly be regarded as giving rise to a form of future benefit. Subject to an impairment test, such expenditure would qualify for recognition as an asset. The auditor will wish to ensure that the accounting treatment is appropriate and that the resulting book value of the resulting asset does not exceed its recoverable amount.

9.4 It will increasingly be necessary to consider the treatment of environmental taxes. These would normally be regarded as an operating cost rather than being included with other taxes or income. However, this is an issue on which clarification by the Accounting Standards Board may be necessary. Environment fines and penalties would also normally be regarded as an operating cost. Where such items are significant, separate disclosure would assist any assessment of environmental performance and might even be necessary to ensure that the financial statements provide a true and fair view.

9.5 FRS 11 requires that, if the recoverable amount of an item of property, plant and equipment has fallen below its carrying amount due to impairment, the carrying amount should be written down and the reduction should be recognised as an expense. Management should therefore carry out impairment reviews periodically to compare the carrying amount with the recoverable amount. Where assets are impaired due to environmental factors, difficulties may arise in determining the recoverable amount or in estimating the timing involved. Measurement of an environmentally impaired asset may be affected by:

(a) delayed disposal of the asset, due to the need to deal with contamination, resulting in clean-up costs and increased interest charges;

(b) uncertainties due to the possibility of improvements in related technology or changes in legislation; and

(c) risks arising from the stigma effect, including migration risk to adjacent sites, deterring potential purchasers and resulting in a more restricted market.

Within these constraints, the auditor will wish to be satisfied that management has considered the issues so as to ensure that any environmentally impaired asset is not stated at an amount that exceeds its recoverable amount.

Q10 Do environmental matters introduce any unusual problems with regard to obtaining audit evidence?

10.1 SAS 400 ‘Audit evidence’ (March 1995) requires auditors to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion (SAS 400.1). Evidence may be obtained from substantive procedures or from tests of control. In the case of environmental matters, tests of control may provide evidence about the design and operation of internal control systems, including any environmental management systems that are in place.
Substantive procedures may provide evidence to support management assertions where these are embodied in items shown in the financial statements, such as:

- the existence, completeness, valuation, presentation and disclosure of an environmental liability;
- the occurrence, measurement, allocation and presentation of environmental expenditure that is capitalised;
- the existence, completeness, valuation and disclosure of environmentally impaired assets; or
- the occurrence, completeness and presentation of environmental fines and penalties.

Where such items are not separately presented and there is no requirement to do so, the auditor considers whether the true and fair view is affected by non-disclosure.

10.2 In the case of environmental matters, uncertainty regarding their incidence, measurement and timing may result in management assertions being particularly subjective, for example as regards existence and completeness. The auditor is likely to encounter similar problems in obtaining evidence to corroborate the assertion, whether this results in an item being presented in the financial statements or in non-disclosure.

10.3 Examples of substantive audit procedures that an auditor may perform to detect a material misstatement due to environmental matters are set out in an illustrative appendix to this discussion paper (Appendix 3). As the introduction to the appendix emphasises, it may not be necessary to perform some or any of these procedures. Where any substantive procedures or tests of control are adopted, appropriate audit evidence should be obtained.

REFERENCE TO ENVIRONMENTAL REPORTS OR STUDIES BY AN ENVIRONMENTAL EXPERT

Q11 If the entity produces a separate environmental report, is the auditor obliged to read it? What action should be taken in the event of any inconsistencies with the financial statements?

11.1 Where a separate environmental report is included within the annual report, this may fall within the scope of SAS 160 ‘Other information in documents containing audited financial statements’ (November 1999). SAS 160 states that the auditors should read the other information and seek to resolve any apparent misstatements or material inconsistencies which they identify. The standard refers to “other information in hard copy documents containing audited financial statements”. It specifically excludes “other information which is released in conjunction with financial statements without the auditors’ knowledge and consent”.

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11.2 SAS 160 requires that, if auditors identify an inconsistency between the financial statements and the other information, or a misstatement within the other information, they should consider whether an amendment is required to the financial statements or to the other information and should seek to resolve the matter through discussion with the directors (SAS 160.2). This would include information that appears to be contradictory or is presented in a misleading manner. For example, there may be environmental matters mentioned in the environmental report that could have a material impact on the financial statements, or the report may give an unduly favourable description of an item which has had a significant financial impact.

11.3 In the case of unresolved misstatements and inconsistencies, the standard requires that if, after discussion with the directors, the auditors conclude:

(a) that the financial statements require amendment and no such amendment is made, they should consider the implication for their report; or

(b) that the other information requires amendment and no such amendment is made, they should consider appropriate action (SAS 160.3).

In the first case, the auditor’s report may need to refer to the inconsistency whereas, in the second case, the auditors may need to seek legal advice on the appropriate action. Environmental reports usually comprise a number of qualitative statements incorporating non-financial information, with which it may be difficult for the auditor to take issue. On the other hand, apparent factual errors, particularly those with a financial impact, should be easier for the auditor and management to resolve.

11.4 If an entity produces an environmental report that does not form part of its annual report containing the audited financial statements, the auditor would not be required to read it. However, if, prior to its release, the auditor becomes aware of the separate environmental report, the auditor will often regard the information in the report as contributing to a knowledge of the business and may therefore read it in this context.

11.5 If the auditor becomes aware of the existence of a risk that the financial statements may be materially misstated due to environmental matters, such as the existence of reports by environmental experts outlining material environmental problems, the auditor should consider the need to re-assess the resulting risk and may need to consult an environmental expert.

Q12 What steps should the auditor take with regard to consulting with environmental experts or obtaining expert assistance? What should the auditor do if information provided by an expert engaged by management appears to be unreliable?

12.1 Management is responsible for estimates included in the financial statements but may require technical advice from specialists, such as environmental experts, engineers or lawyers to assist in developing accounting estimates and disclosures related to environmental matters. For example, experts may assist management in:
• identifying situations where the recognition of environmental liabilities and contingencies, including related estimates, is required;

• gathering data on which to base estimates on environmental matters including the impact of environmental impairment and providing information for disclosure in the financial statements; and

• proposing remedial action and calculating the related financial consequences.

If it is intended to use the results of such work as part of the audit, the auditor considers its adequacy for the purposes of the audit, as well as the expert’s competence and objectivity, in accordance with SAS 520 ‘Using the work of an expert’ (March 1995).

12.2 Estimates developed by the expert may be set out in the form of a report or provided directly to management. In principle, the use of estimates provided by an environmental expert raises no new issues for the auditor as compared with evidence on other matters that is provided by, for example, valuers, actuaries and lawyers. Reports by experts include those relating to independent checks required under environmental legislation, for example an environmental impact assessment.

12.3 If a report has been issued and the auditor intends to place reliance on it, the auditor may communicate with the expert to assist in understanding the nature and scope of the report. This would include any limitations of the expert’s report, for example, the report may be restricted to cost estimates relating to only one aspect of environmental contamination. It will usually be necessary for the auditor to consider the scope of the expert’s work, whether the expert has appropriate experience and the assumptions and procedures adopted, including the nature of source data used.

12.4 If the information provided by an expert engaged by management appears to be unreliable, the auditor should try to persuade management to rectify the position, possibly by obtaining a second opinion. Alternatively, the auditor may need to engage another expert or to adopt additional audit procedures. If the issue remains unresolved, it may be necessary to modify the audit report.

MANAGEMENT REPRESENTATIONS

Q13 Should the auditor obtain any additional representations from management about the effect of environmental matters on the financial statements?

13.1 SAS 440 ‘Management representations’ requires that auditors obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist. Much of the evidence available to auditors regarding the impact of environmental matters on the financial statements will be persuasive in nature rather than conclusive. Where environmental matters may be significant to the
financial statements, an auditor may therefore wish to obtain specific representation that management:

(a) is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;

(b) is not aware of any other environmental matters that may have a material impact on the financial statements; or

(c) if aware of such matters, has disclosed them properly in the financial statements.
Appendix 1

ENVIRONMENTAL ISSUES IN THE AUDIT OF FINANCIAL STATEMENTS

- MEMBERS OF THE WORKING PARTY

Tony Upson (Chairman) Pannell Kerr Forster/Audit Faculty
Meredith Coombs (Vice chairman) London Transport
Harbinder Bains KPMG
David Collison University of Dundee
Alex Spofforth Spofforths/Technical Advisory Committee
Margaret de Wolf Forum of Private Business
Robert Langford Head of Financial Reporting, ICAEW
This appendix provides examples of questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity’s system of internal control.

These examples are included for illustrative purposes only. It is not intended that all of the questions illustrated will be appropriate in any particular case. In many cases, the auditor may judge it unnecessary to consider any of these questions.

Knowledge of the business

1. Does the nature of an entity’s operations expose it to significant environmental risk that may affect the financial statements of the entity?

2. Which environmental laws and regulations are of particular relevance to the entity?

3. Do enforcement agencies monitor the entity’s compliance with the requirements of environmental laws, regulations or licenses? If so, what are the principal agencies involved?

4. Have enforcement agencies taken any regulatory actions or issued any reports that may have a material impact on the entity and its financial statements?

5. What initiatives are proposed to prevent, reduce or remedy damage to the environment?

6. Is there a history of penalties and legal proceedings against the entity or its directors in connection with environmental matters? If so, what were the reasons?

7. Are any legal proceedings pending with regard to compliance with environmental laws and regulations?

8. Are environmental risks covered by insurance?

Internal control systems

9. What is management’s attitude and operating style with respect to environmental control in general?

10. Does the entity’s operating structure include assigning responsibility for environmental control, including board level responsibility, to specified
individuals?

11. Does the entity operate an environmental information system or an environmental management system?

12. Are procedures in place to identify and assess environmental risk, and to monitor any mitigating actions and controls? Does the entity have a procedure to ensure compliance with environmental laws and regulations, and to assess the impact of possible changes in environmental legislation likely to affect the entity?

13. Does the entity operate control procedures for handling and disposal of waste, including special waste, in compliance with legal requirements?

14. Is management aware of the existence, and the potential impact on the entity’s financial statements, of any risk of liabilities arising as a result of pollution of soil, groundwater, surface water, or air?
This appendix provides examples of substantive procedures that an auditor may perform. These examples are included for illustrative purposes only. It is not intended that all of the procedures illustrated will be appropriate in any particular case. In many cases, the auditor may judge it unnecessary to perform any of these procedures.

General

Documentary review

1. Consider minutes from meetings of directors, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.

2. Consider publicly available information regarding any existing or possible future environmental matters.

3. Where relevant, consider:
   - reports by environmental experts about the entity, such as site assessments, due diligence investigations or environmental impact studies;
   - internal audit reports and other internal reports dealing with environmental matters;
   - reports issued by, and correspondence with, regulatory and enforcement agencies;
   - publicly available registers or plans for the restoration of soil contamination; and
   - correspondence with the entity’s lawyers.

4. Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:
   - is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;
   - is not aware of environmental matters that may result in a material impairment of assets; or
if aware of such matters, has disclosed to the auditor all related facts.

**Assets**

*Asset impairment*

5. Enquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy and their impact on the valuation of those assets or the company as a whole.

6. For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down of related carrying values continue to be appropriate.

**Liabilities, provisions and contingencies**

*Completeness*

7. Enquire about policies and procedures operated to identify liabilities, provisions or contingencies arising from environmental matters.

8. Enquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example:

   - Penalties or possible penalties arising from breaches of environmental laws and regulations; or

   - Claims or possible claims for environmental damage.

9. For property abandoned, purchased, or closed during the period, enquire about requirements or intentions for site clean-up and restoration.

10. For property sold during the period and in prior periods, enquire about any liabilities relating to environmental matters retained by contract or by law.

*Accounting estimates*

11. For liabilities, provisions, or contingencies related to environmental matters, consider whether the assumptions underlying the estimates continue to be appropriate.

**Disclosure**

12. Review the adequacy of any disclosure of the effects of environmental matters on the financial statements.
ENVIROMENTAL ISSUES IN THE AUDIT OF FINANCIAL STATEMENTS
- ENVIRONMENTAL LAWS AND REGULATIONS

In a paper of this nature, it would be impossible to give a resumé of the growing body of environmental law in the UK, much of which arises at European Community level. Recently, for example, the EU Environment Commissioner has called for wide-ranging legislation to guarantee that companies are liable for any environmental damage caused by the products they manufacture. With the number of new regulations coming into force, the list would need to be updated frequently. Environmental law is also becoming quite a complex area; indeed, many law firms have their own specialists on the subject and entities that believe they may be affected would be well advised to take professional advice.

It has been suggested that many entities, particularly small and medium sized enterprises, are largely unaware of the actual and potential implications of environmental legislation affecting their operations. For present purposes, it may therefore be helpful to auditors to indicate briefly some of the principal legal instruments that may have an impact on UK entities. Regulations of a specialised nature, such as those whose scope is restricted to individual industry sectors, are excluded as are environmental laws issued after 31 December 1999.

The Environmental Protection Act 1990

Part I of the Act first introduced the concept of integrated pollution control (air, water and land) requiring an operator of a prescribed industrial process to obtain prior authorisation, based on the use of best available techniques not entailing excessive cost (BATNEEC).

Part II of the Act introduced a new licensing regime for waste management, with a strict ‘duty of care’ to prevent illegal disposal of controlled waste.

Parts III to VIII deal with various other matters such as statutory nuisances, clean air, litter and nature conservation, all of which may be relevant to UK businesses.

Water Industry Act 1991

Regulates the water industry and covers the control of trade effluent to the public sewerage system.

Water Resources Act 1991

Prohibits polluting discharges to ‘controlled waters’ (rivers, water courses and the sea) and establishes a consent regime for discharges to, and abstractions from, watercourses.

Clean Air Act 1993

Consolidates existing controls on dark smoke, chimneys, grit and dust; strengthens powers of Local Authorities in dealing with nuisances, including anticipated problems.
Environment Act 1995

Established the Environment Agency as the main regulatory body.

Introduces a requirement for Local Authorities to identify contaminated land. The regime will address contaminated sites that pose a severe risk to human health or the environment. It underlines the need for careful assessment of environmental risk arising from land ownership, particularly when negotiating the sale and purchase of property or entering into leasehold transactions.


Requires the environmental assessment of certain major projects before the grant of planning permission.

Pollution Prevention and Control Act 1999

Strengthens and expands the Integrated Pollution, Prevention and Control (IPPC) regime, a requirement of EC law; will extend integrated control to 5000 extra industrial sites and cover a wider range of environmental impacts.