

**INTERNATIONAL AUDITING  
PRACTICE STATEMENT 1010**

**THE CONSIDERATION OF ENVIRONMENTAL MATTERS IN  
THE AUDIT OF FINANCIAL STATEMENTS**

(This Statement is effective)

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International Auditing Practice Statement (IAPS) 1010, “The Consideration of Environmental Matters in the Audit of Financial Statements” should be read in the context of the “Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services,” which sets out the application and authority of IAPSs.

This Statement was approved by the IAPC in March 1998 for publication in March 1998.

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<sup>1</sup> ISA 310, “Knowledge of the Business” was withdrawn in December 2004 when ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” became effective.

<sup>2</sup> ISA 400, “Risk Assessments and Internal Control” was withdrawn in December 2004 when ISA 315, “Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement” and ISA 330, “The Auditor’s Procedures in Response to Assessed Risks” became effective.

## Introduction

### The Purpose of this Statement

1. Environmental matters are becoming significant to an increasing number of entities and may, in certain circumstances, have a material impact on their financial statements. These issues are of growing interest to the users of financial statements. The recognition, measurement, and disclosure of these matters is the responsibility of management.
2. For some entities, environmental matters are not significant. However, when environmental matters are significant to an entity, there may be a risk of material misstatement (including inadequate disclosure) in the financial statements arising from such matters: in these circumstances, the auditor needs to give consideration to environmental matters in the audit of the financial statements.
3. Environmental matters can be complex and may therefore require additional consideration by auditors. This Statement provides practical assistance to auditors by describing:
  - (a) The auditor's main considerations in an audit of financial statements with respect to environmental matters;
  - (b) Examples of possible impacts of environmental matters on financial statements; and
  - (c) Guidance that the auditor may consider when exercising professional judgment in this context to determine the nature, timing, and extent of audit procedures with respect to:
    - (i) Knowledge of the business (ISA 310, "Knowledge of the Business");<sup>3</sup>
    - (ii) Risk assessments and internal control (ISA 400, "Risk Assessments and Internal Control");<sup>4</sup>
    - (iii) Consideration of laws and regulations (ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements"); and
    - (iv) Other substantive procedures (ISA 620, "Using the Work of an Expert" and some others).

The guidance under (c) reflects the typical sequence of the audit process. Having acquired a sufficient knowledge of the business the auditor assesses the risk of a material misstatement in the financial statements. This assessment includes

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<sup>3</sup> See footnote 1.

<sup>4</sup> See footnote 2.

consideration of environmental laws and regulations that may pertain to the entity, and provides a basis for the auditor to decide whether there is a need to pay attention to environmental matters in the course of the audit of financial statements.

Appendix 1 provides illustrative questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures from an environmental point of view. Appendix 2 provides examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial statements due to environmental matters. These appendices are included for illustrative purposes only. It is not intended that all, or even any, of the questions or examples will necessarily be appropriate in any particular case.

4. This Statement does not establish any new basic principles or essential procedures: its purpose is to assist auditors, and the development of good practice, by providing guidance on the application of the ISAs in cases when environmental matters are significant to the financial statements of the entity. The extent to which any of the audit procedures described in this Statement may be appropriate in a particular case requires the exercise of the auditor's judgment in the light of the requirements of the ISAs and the circumstances of the entity.
5. The Statement does not provide guidance on the audit of the financial statements of insurance companies with regard to claims incurred under insurance policies relating to environmental matters affecting policyholders.

#### **The Auditor's Main Considerations with Respect to Environmental Matters**

6. The objective of an audit of financial statements is:

*“to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.”* (ISA 200, “Objective and General Principles Governing an Audit of Financial Statements,” paragraph 2.)
7. The auditor's opinion relates to the financial statements taken as a whole and not to any specific aspect. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit can not be expected to detect noncompliance with all laws and regulations (ISA 250, paragraph 2). In particular, with respect to the entity's compliance with environmental laws and regulations, the auditor's purpose is not to plan the audit to detect possible breaches of environmental laws and regulations; nor are the auditor's procedures sufficient to draw a conclusion on the entity's compliance with environmental laws and regulations or the adequacy of its controls over environmental matters.

8. In all audits, when developing the overall audit plan, the auditor assesses inherent risk at the financial statement level (ISA 400, paragraph 11<sup>5</sup>). The auditor uses professional judgment to evaluate the factors relevant to this assessment. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters. The need to consider, and extent of the consideration of, environmental matters in an audit of financial statements depends on the auditor's judgment as to whether environmental matters give rise to a risk of material misstatement in the financial statements. In some cases, no specific audit procedures may be judged necessary. In other cases, however, the auditor uses professional judgment to determine the nature, timing and extent of the specific procedures considered necessary in order to obtain sufficient appropriate audit evidence that the financial statements are not materially misstated. If the auditor does not have the professional competence to perform these procedures, technical advice may be sought from specialists, such as lawyers, engineers, or other environmental experts.
9. To conclude that an entity operates in compliance with existing environmental laws or regulations ordinarily requires the technical skills of environmental experts, which the auditor cannot be expected to possess. Also, whether a particular event or condition that comes to the attention of the auditor is a breach of environmental laws and regulations is a legal determination that is ordinarily beyond the auditor's professional competence. However, as with other laws and regulations:

*“the auditor’s training, experience and understanding of the entity and its industry may provide a basis for recognition that some acts coming to the auditor’s attention may constitute noncompliance with laws and regulations. The determination as to whether a particular act constitutes or is likely to constitute noncompliance is generally based on the advice of an informed expert qualified to practice law but ultimately can only be determined by a court of law.” (ISA 250, paragraph 4.)*

#### **Environmental Matters and their Impact on the Financial Statements**

10. For the purpose of this Statement, “environmental matters” are defined as:
  - (a) Initiatives to prevent, abate, or remedy damage to the environment, or to deal with 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;

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<sup>5</sup> See footnote 2.

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- (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).
11. Some examples of environmental matters affecting the financial statements are the following:
- The introduction of environmental laws and regulations may involve an impairment of assets and consequently a need to write down their carrying value.
  - Failure to comply with legal requirements concerning environmental matters, such as emissions or waste disposal, or changes to legislation with retrospective effect, may require accrual of remediation, compensation or legal costs.
  - Some entities, for example in the extraction industries (oil and gas exploration or mining), chemical manufacturers or waste management companies may incur environmental obligation as a direct by-product of their core businesses.
  - Constructive obligations that stem from a voluntary initiative, for example an entity may have identified contamination of land and, although under no legal obligation, it may have decided to remedy the contamination, because of its concern for its long-term reputation and its relationship with the community.<sup>6</sup>
  - An entity may need to disclose in the notes the existence of a contingent liability where the expense relating to environmental matters cannot be reasonably estimated.
  - In extreme situations, noncompliance with certain environmental laws and regulations may affect the continuance of an entity as a going concern and consequently may affect the disclosures and the basis of preparation of the financial statements.

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<sup>6</sup> The term “constructive obligations” (as opposed to “present legal obligations”) has been clarified by the International Accounting Standards Committee as follows: “Sometimes the actions or representations of the enterprise’s management, or changes in the economic environment, directly influence the reasonable expectations or actions of those outside the enterprise and, although they have no legal entitlement, they have other sanctions that leave the enterprise with no realistic alternative to certain expenditures. Such obligations are sometimes called “constructive obligations” (IASC: ED 59 Proposed International Accounting Standard on “Provisions, Contingent Liabilities and Contingent Assets,” paragraph 16).

Subsequent to the issue of this Statement, International Accounting Standard (ISA) 37, “Provisions, Contingent Liabilities and Contingent Assets” was issued.

12. As of the date of publication of this Statement there are few authoritative accounting standards, whether International Accounting Standards or national standards, that explicitly address the recognition, measurement, and disclosure of the consequences for the financial statements arising from environmental matters. However, existing accounting standards generally do provide appropriate general considerations that also apply to the recognition, measurement and disclosure of environmental matters in financial statements.<sup>7</sup>

### **Guidance on the Application of ISA 310, “Knowledge of the Business”<sup>8</sup>**

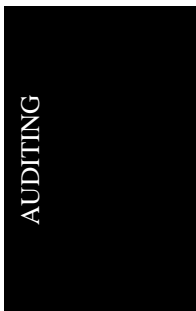
13. In all audits a sufficient knowledge of the client’s business is needed to enable the auditor to identify and understand matters that may have a significant effect on the financial statements, the audit process and the audit report (ISA 310, paragraph 2). In obtaining a sufficient knowledge of the business, the auditor considers important conditions affecting the entity’s business and the industry in which it operates, such as environmental requirements and problems.
14. The auditor’s level of knowledge with regard to environmental matters, appropriate for a particular engagement is less than that ordinarily possessed by management or by environmental experts. However, the auditor’s level of knowledge needs to be sufficient to enable the auditor to identify and obtain an understanding of the events, transactions, and practices related to environmental matters that may have a material effect on the financial statements and on the audit.
15. The auditor considers the industry in which the entity operates, as it may be indicative of the possible existence of environmental liabilities and contingencies. Certain industries, by their nature, tend to be exposed to significant environmental risk.<sup>9</sup> These include the chemical, oil and gas, pharmaceutical, metallurgical, mining, and utility industries.
16. An entity does not, however, need to operate in one of these industries to be exposed to significant environmental risk. Potential exposure to significant environmental risk may in general arise for any entity that:
- (a) Is subject to environmental laws and regulations to a substantial degree;

<sup>7</sup> For example, International Accounting Standard (IAS) 10, “Contingencies and Events Occurring After the Balance Sheet Date,” provides the general considerations which apply to the recognition and disclosure of contingent losses, including losses as a consequence of environmental matters. IAS 10 is currently under review by IASC. ED:59 Proposed International Accounting Standard on “Provisions, Contingent Liabilities and Contingent Assets,” contains some examples of environmental liabilities.

Subsequent to the issue of this Statement, IAS 10, “Events After the Balance Sheet Date” and IAS 37, “Provisions, Contingent Liabilities and Contingent Assets” were issued.

<sup>8</sup> See footnote 1.

<sup>9</sup> “Environmental risk” is defined in paragraph 18 of this Statement as a possible component of inherent risk.



- (b) Owns, or holds security over, sites contaminated by previous owners (“vicarious liability”); or
- (c) Has business processes that:
  - (i) May cause contamination of soil and groundwater, contamination of surface water, or air pollution;
  - (ii) Use hazardous substances;
  - (iii) Generate or process hazardous waste; or
  - (iv) May have an adverse impact on customers, employees, or people that live in the neighborhood of the company’s sites.

### **Guidance on the Application of ISA 400, “Risk Assessments and Internal Control”<sup>10</sup>**

17. This section of the Statement provides additional guidance on the application of certain aspects of ISA 400 by explaining the relationship between environmental matters and the audit risk model. More specifically, it provides examples of the auditor’s possible consideration of environmental matters with respect to the:
- (a) Inherent risk assessment;
  - (b) Accounting and internal control systems;
  - (c) Control environment; and
  - (d) Control procedures.

#### **Inherent Risk**

18. The auditor uses professional judgment to evaluate the factors relevant to the assessment of inherent risk for the development of the overall audit plan. In certain circumstances these factors may include the risk of material misstatement of the financial statements due to environmental matters (“environmental risk”). Thus, environmental risk may be a component of inherent risk.
19. Examples of environmental risk at financial statement level are:
- The risk of compliance costs arising from legislation or from contractual requirements;
  - The risk of noncompliance 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.

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<sup>10</sup> See footnote 2.

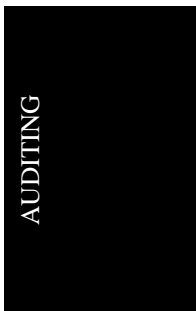
20. If the auditor considers that environmental risk is a significant component in the inherent risk assessment, the auditor relates this assessment to material account balances and classes of transactions at the assertion level when developing the audit program (ISA 400, paragraph 11).
21. Examples of environmental risk at the level of account balances or classes of transactions are:
  - The extent to which an account balance is based on complex accounting estimates with respect to environmental matters (for example, the measurement of an environmental provision for the removal of contaminated land and future site restoration). ISA 540, “Audit of Accounting Estimates” provides guidance to the auditor for these situations. Inherent risk may be high if there is a lack of data upon which to base a reasonable estimate, for example because of complex technologies for removal and site restoration; and
  - The extent to which an account balance is affected by unusual or non-routine transactions involving environmental matters.

#### **Accounting and Internal Control Systems**

22. It is management’s responsibility to design and operate internal controls to assist in achieving, as far as practicable, the orderly and efficient conduct of the business, including any environmental aspects. The way in which management achieves control over environmental matters differs in practice:
  - Entities with low exposure to environmental risk, or smaller entities, will probably monitor and control their 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 for this purpose, that conforms with existing standards for Environmental Management Systems (EMS);<sup>11</sup> and
  - Other entities design and operate all of their controls in an integrated control system, encompassing policies and procedures related to

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<sup>11</sup> Standards for an EMS have been issued by the International Organization for Standardization (ISO 14001: “Environmental Management Systems—Specification with Guidance for Use,” International Organization for Standardization, Geneva, Switzerland, First edition 1996–09–01). The specification requires participating organizations to develop and implement a systematic approach to managing significant environmental aspects. It also includes a commitment to continual improvement. When in certain countries or regions other standards for an EMS are in use, such as the standards issued by the European Commission on behalf of an entity’s participation in the Eco-Management and Audit Scheme (EMAS), those national or regional standards can be used by the entity as benchmarks also.





accounting, environmental and other matters (for example, quality, health and safety).

23. For the auditor's purposes it makes no difference how management actually achieves control over environmental matters. In particular, the lack of an EMS does not in itself mean that the auditor has to conclude that there is inadequate control over the environmental aspects of the business.
24. Only if, in the auditor's judgment, environmental matters may have a material effect on the financial statements of an entity, does the auditor need to obtain an understanding of the entity's significant policies and procedures with respect to its monitoring of, and control over these environmental matters (the entity's "environmental controls"), in order to plan the audit and develop an effective audit approach. In such cases the auditor is only concerned with those environmental controls (within or outside the accounting and internal control systems) that are considered relevant to the audit of the financial statements.

### **Control Environment**

25. In all audits, the auditor obtains an understanding of the control environment sufficient to assess directors' and management's attitudes, awareness, and actions regarding internal controls and their importance in the entity (ISA 400, paragraph 19). Similar conditions as described in paragraph 24 of this Statement apply to the auditor's need to obtain an understanding of the control environment. Factors in obtaining an understanding of the control environment with respect to environmental matters may include:
  - The functioning of the board of directors and its committees, with respect to the entity's environmental controls;
  - Management's philosophy and operating style and its approach to environmental issues, such as any efforts to improve the environmental performance of the entity, participation in certification programs for the entity's EMS, and the voluntary publication of environmental performance reports.<sup>12</sup> This also encompasses management's reaction to external influences such as those relating to monitoring and compliance requirements imposed by regulatory bodies and enforcement agencies;
  - The entity's organizational structure and methods of assigning authority and responsibility to deal with environmental operating functions and regulatory requirements; and

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<sup>12</sup> An "environmental performance report" is a report, separate from the financial statements, in which an entity provides third parties with qualitative information on the entity's commitments towards the environmental aspects of the business, its policies and targets in that field, its achievement in managing the relationship between its business processes and environmental risk, and quantitative information on its environmental performance.

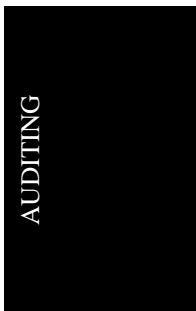
- Management’s control system, including the internal auditing function, the performance of “environmental audits” (see paragraph 45 of this Statement), personnel policies, and procedures and appropriate segregation of duties.

### **Control Procedures**

26. Applying the considerations and conditions mentioned in paragraphs 18–20 the auditor may come to the conclusion that there is a need to obtain an understanding of environmental controls. Examples of environmental controls are policies and procedures:
- To monitor compliance with the entity’s environmental policy, as well as with relevant environmental laws and regulations;
  - To maintain an appropriate environmental information system, which may include recording of, for example, physical quantities of emissions and hazardous waste, environmental characteristics of products, complaints from stakeholders, results of inspections performed by enforcement agencies, occurrence and effects of incidents, etc;
  - To provide for the reconciliation of environmental information with relevant financial data, for example, physical quantities of waste production in relation to cost of waste disposal; and
  - To identify potential environmental matters and related contingencies affecting the entity.
27. If the entity has established environmental controls, the auditor also inquires of those persons overseeing such controls as to whether any environmental matters have been identified that may have a material effect on the financial statements.
28. One of the possibilities for the auditor to obtain an understanding of the entity’s control over environmental matters may be to read the entity’s environmental performance report, if available. That report often discloses the entity’s environmental commitments and policies, and its major environmental controls.

### **Control Risk**

29. After obtaining an understanding of the accounting and internal control systems, the auditor may need to consider the effect of environmental matters in the assessment of control risk and in any tests of control that may be necessary to support that assessment. (The auditor’s assessment of control risk is described in paragraphs 21–39 of ISA 400.)



## **Guidance on the Application of ISA 250, “Consideration of Laws and Regulations in an Audit of Financial Statements”**

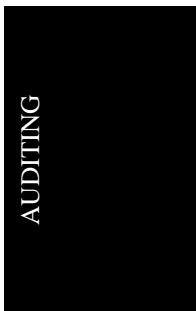
30. It is management’s responsibility to ensure that the entity’s operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management (ISA 250, paragraph 9). In this context, management has to take into account:
- Laws and regulations that impose liability for remediation of environmental pollution arising from past events; this liability may not be limited to the entity’s own actions but may also be imposed on the current owner of a property where the damage was incurred by a previous owner (“vicarious liability”);
  - Pollution control and pollution prevention laws that are directed at identifying or regulating sources of pollution, or reducing emissions or discharges of pollutants;
  - Environmental licenses that, in certain jurisdictions, specify the entity’s operating conditions from an environmental point of view, for example, a specification of the maximum levels of emissions; and
  - The requirements of regulatory authorities with respect to environmental matters.
31. Changes in environmental legislation could have significant consequences for the operations of the entity and may even result in liabilities that relate to past events which, at the time, were not governed by legislation. An example of the first category is a change in noise regulations that could curtail future use of plant or machinery. An example of the latter is an increase in standards that could render a waste generator liable for waste disposed of in previous years, even though disposal of the waste was in compliance with the then existing practice.
32. The auditor is not, and cannot be held responsible for preventing noncompliance with environmental laws and regulations. Also, as stated in paragraph 9, the detection of possible breaches of environmental laws and regulations is ordinarily beyond the auditor’s professional competence. However, an audit carried out in accordance with ISAs is planned and performed with an attitude of professional skepticism, recognizing that the audit may reveal conditions or events that would lead to questioning whether the entity is complying with relevant environmental laws and regulations in so far as noncompliance could result in a material misstatement of the financial statements.
33. As part of the planning process of the audit, the auditor obtains a general understanding of such environmental laws and regulations which, if violated, could reasonably be expected to result in a material misstatement in the financial statements, and of the policies and procedures used by the entity to comply with

those laws and regulations. In obtaining this general understanding, the auditor recognizes that noncompliance with some environmental laws and regulations may severely impact the operations of the entity.

34. To obtain a general understanding of relevant environmental laws and regulations, the auditor ordinarily:
- Uses existing knowledge of the entity's industry and business;
  - Inquires of management (including key officers for environmental matters) concerning the entity's policies and procedures regarding compliance with relevant environmental laws and regulations;
  - Inquires of management as to the environmental laws and regulations that may be expected to have a fundamental effect on the operations of the entity. Noncompliance with these requirements might cause the entity to cease operations, or call into question the entity's continuance as a going concern; and
  - Discusses with management the policies or procedures adopted for identifying, evaluating and accounting for litigation, claims and assessments.

### **Substantive Procedures**

35. This section of the Statement provides guidance on substantive procedures, including the application of ISA 620, "Using the Work of an Expert."
36. The auditor considers the assessed levels of inherent and control risk in determining the nature, timing and extent of substantive procedures required to reduce the risk of not detecting a material misstatement in the financial statements to an acceptable level, including any material misstatements if the entity fails to properly recognize, measure or disclose the effects of environmental matters.
37. Substantive procedures include obtaining evidence through inquiry of both management responsible for the preparation of the financial statements and key officers responsible for environmental matters. The auditor considers the need to gather corroborative audit evidence for any environmental assertions from sources inside or outside the entity. In certain situations, the auditor may need to consider using the work of environmental experts.
38. Examples of substantive procedures that an auditor may perform to detect a material misstatement in the financial statements due to environmental matters, are provided in Appendix 2.
39. Most of the audit evidence available to the auditor is persuasive rather than conclusive. Therefore, the auditor needs to use professional judgment in determining whether the planned substantive procedures, either individually or



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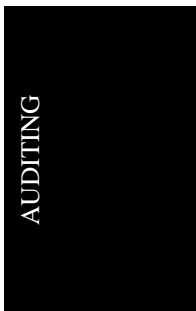
in combination, are appropriate. The use of professional judgment may become even more important because of a number of difficulties with respect to the recognition and measurement of the consequences of environmental matters in the financial statements, for example:

- Often there is a considerable time delay between the activity that basically causes an environmental issue, and the identification of it by the entity or 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 of 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 appear to be difficult in practice; or
  - Liabilities may arise other than as a result of legal or contractual obligations.
40. In the course of the audit process, for example in gathering knowledge of the business, in the assessments of inherent and control risk, or in performing certain substantive procedures, evidence may come to the attention of the auditor that indicates the existence of a risk that the financial statements may be materially misstated due to environmental matters. Examples of such circumstances include:
- The existence of reports outlining material environmental problems prepared by environmental experts, internal auditors or environmental auditors;
  - Violations of environmental laws and regulations cited in correspondence with, or in reports issued by, regulatory agencies;
  - Inclusion of the entity's name in a publicly available register, or plan, for the restoration of soil contamination (if one exists);
  - Media comment about the entity related to major environmental matters;
  - Comments relating to environmental matters made in lawyers' letters;
  - Evidence indicating purchases of goods and services relating to environmental matters that are unusual in relation to the nature of the entity's business;

- Increased or unusual legal or environmental consultants' fees, or payments of penalties as a result of violation of environmental laws and regulations; and
- In these circumstances the auditor considers the need to re-assess inherent and control risk and the resulting impact on detection risk. If necessary, the auditor may decide to consult an environmental expert.

### **Environmental Experts**

41. Management is responsible for accounting estimates included in the financial statements. Management may require technical advice from specialists such as lawyers, engineers or other environmental experts to assist in developing accounting estimates and disclosures related to environmental matters. Such experts may be involved in many stages in the process of developing accounting estimates and disclosures, including assisting management in:
  - Identifying situations where the recognition of liabilities and related estimates is required (for example, an environmental engineer may make a preliminary investigation of a site to determine if contamination has occurred, or a lawyer may be used to determine the entity's legal responsibility to restore the site);
  - Gathering the necessary data on which to base estimates and providing details of information that needs to be disclosed in the financial statements (for example, an environmental expert may test a site in order to assist in quantifying the nature and extent of contamination and considering acceptable alternative methods of site restoration); and
  - Designing the appropriate remedial action plan and calculating related financial consequences.
42. If the auditor intends to use the results of such work as part of the audit, the auditor considers the adequacy of the work performed by environmental experts for the purposes of the audit, as well as the expert's competence and objectivity, in accordance with ISA 620. The auditor may need to engage another expert in considering such work, to apply additional procedures, or to modify the auditor's report.
43. As the environmental area is an emerging specialty, the expert's professional competence may be more difficult to assess than is the case with some other experts, because there may be no certification or licensing by, or membership of, an appropriate professional body. In this situation, it may be necessary for the auditor to give particular consideration to the experience and reputation of the environmental expert.
44. Timely and ongoing communication with the expert may assist the auditor to understand the nature, scope, objective and limitations of the expert's report.



The report might deal with only one aspect of the entity's operations. For example, the expert's report may be based on cost estimates related to only one element of a particular issue (for example, soil contamination), rather than on cost estimates of all relevant issues (for example, contamination of soil and groundwater, including vicarious liability imposed by law). It is also necessary for the auditor to discuss the assumptions, methods, procedures, and source data used by the expert.

### **Environmental Audit**

45. "Environmental audits" are becoming increasingly common in certain industries.<sup>13</sup> The term "environmental audit" has a wide variety of meanings. They can be performed by external or internal experts (sometimes including internal auditors), at the discretion of the entity's management. In practice, persons from various disciplines can qualify to perform "environmental audits." Often the work is performed by a multi-disciplinary team. Normally, "environmental audits" are performed at the request of management and are for internal use. They may address various subject matters, including site contamination, or compliance with environmental laws and regulations. However, an "environmental audit" is not necessarily an equivalent to an audit of an environmental performance report.
46. The auditor of the entity's financial statements may consider using the findings of "environmental audits" as appropriate audit evidence. In that situation the auditor has to decide whether the "environmental audit" meets the evaluation criteria included in ISA 610, "Considering the Work of Internal Auditing" or ISA 620. Important criteria to be considered are:
  - (a) The impact of the results of the environmental audit on the financial statements;
  - (b) The competency and skill of the environmental audit team and the objectivity of the auditors, specially when chosen from the entity's staff;
  - (c) The scope of the environmental audit, including management's reactions to the recommendations that result from the environmental audit and how this is evidenced;
  - (d) The due professional care exercised by the team in the performance of the environmental audit; and
  - (e) The proper direction, supervision, and review of the audit.

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<sup>13</sup> Guidelines for "environmental auditing" have been issued by the International Organization for Standardization (ISO), "Guidelines for Environmental Auditing—General Principles" (International Organization for Standardization, Geneva, Switzerland, First Edition 1996–10–01).

### **Internal Audit**

47. If the entity has an internal auditing function, the auditor considers whether the internal auditors address environmental aspects of the entity's operations as part of their internal auditing activities. If this is the case, the auditor considers the appropriateness of using such work for the purpose of the audit, applying the criteria set out in ISA 610.

### **Management Representations**

48. ISA 580, "Management Representations" requires that the auditor 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 the auditor with respect to the impact of environmental matters on the financial statements will be persuasive in nature rather than conclusive. The 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.

### **Reporting**

49. When forming an opinion on the financial statements, the auditor considers whether the effects of environmental matters are adequately treated or disclosed in accordance with the appropriate financial reporting framework. In addition, the auditor reads any other information to be included with the financial statements in order to identify any material inconsistencies, for example, regarding environmental matters.
50. Management's assessment of uncertainties and the extent of their disclosure in the financial statements are key issues in determining the impact on the auditor's report. The auditor may conclude that there are significant uncertainties, or inappropriate disclosures, due to environmental matters. There may even be circumstances when, in the auditor's judgment, the going concern assumption is no longer appropriate. ISA 700, "The Auditor's





Report on Financial Statements”<sup>14</sup> and ISA 570, “Going Concern” provide detailed guidance to auditors in these circumstances.

### **Public Sector Perspective**

1. *As stated in paragraph 3, this Statement provides practical assistance to auditors in identifying and addressing environmental matters in the context of an audit of financial statements. This guidance would generally be equally applicable to public sector auditors in their audit of the financial statements of governments and other public sector entities. However, it should be noted that the nature and scope of public sector audit engagements may be affected by legislation, regulation, ordinances and ministerial directives that impose additional audit or reporting responsibilities with respect to environmental issues.*
2. *As in the private sector, auditors of financial statements of governments and other public sector entities may need to consider the recognition, measurement and disclosure of any liabilities or contingencies for environmental damage. Liabilities or contingencies may arise through damage caused by the reporting entity or one of its agencies. However, in the public sector, liability or contingencies may also arise when the government accepts responsibility for clean-up or other costs associated with damage caused by others, if, for example, responsibility is unresolved or cannot be attributed to others.*
3. *Public sector auditors may, in some countries, be obliged to report instances of noncompliance with environmental regulations found in the course of a financial statement audit, regardless of whether or not those instances of noncompliance have a material impact on the entity’s financial statements.*
4. *A government’s responsibilities may also include the monitoring of compliance with laws and regulations in relation to environmental matters. More specifically, this monitoring role will be the responsibility of a particular public sector agency or agencies. In performing the financial statement audit of such an agency or agencies the auditor may need to consider, for example, controls covering the imposing of appropriate charges/fines and the collection of fines. For unresolved cases consideration may also need to be given to the recognition, measurement and disclosure of any liabilities or contingencies.*

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<sup>14</sup> ISA 700, “The Auditor’s Report on Financial Statements” was withdrawn in December 2006 when ISA 700, “The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements” became effective.

## Appendix 1

### Obtaining Knowledge of the Business from an Environmental Point of View—Illustrative Questions

The purpose of this appendix is to provide examples of questions that an auditor may consider when obtaining a knowledge of the business, including an understanding of the entity's control environment and control procedures, from an environmental point of view.

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. The questions need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to address any of these questions.

It may be necessary for the auditor to consult an environmental expert when evaluating the answers received from the entity's officers in response to any inquiries with regard to environmental matters.

#### Knowledge of the Business

1. Does the entity operate in an industry that is exposed to significant environmental risk that may adversely affect the financial statements of the entity?
2. What are the environmental issues in the entity's industry in general?
3. Which environmental laws and regulations are applicable to the entity?
4. Are there any substances used in the entity's products or production processes that are part of a phase-out scheme required by legislation, or adopted voluntarily by the industry in which the client operates?
5. Do enforcement agencies monitor the entity's compliance with the requirements of environmental laws, regulations or licenses?
6. Have any regulatory actions been taken or reports been issued by enforcement agencies that may have a material impact on the entity and its financial statements?
7. Have initiatives been scheduled to prevent, abate or remedy damage to the environment, or to deal with conservation of renewable and non-renewable resources?
8. 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 for such actions?

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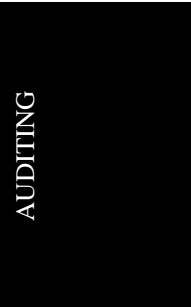
9. Are any legal proceedings pending with regard to compliance with environmental laws and regulations?
10. Are environmental risks covered by insurance?

**Control Environment and Control Procedures**

11. What is management's philosophy and operating style with respect to environmental control in general (to be assessed by the auditor, based on his knowledge of the entity in general)?
12. Does the entity's operating structure include assigning responsibility, including segregation of duties, to specified individuals for environmental control?
13. Does the entity maintain an environmental information system, based on requirements by regulators or the entity's own evaluation of environmental risks? This system may provide, for example, information about physical quantities of emissions and hazardous waste, eco-balances, environmental characteristics of the entity's products and services, results from inspections performed by enforcement agencies, information about the occurrence and effects of incidents, and the number of complaints made by stakeholders.
14. Does the entity operate an Environmental Management System (EMS)? If so, has the EMS been certified by an independent certification body? Examples of recognized standards for an EMS are the international standard ISO 14001 and the European Commission's Eco-Management and Audit Scheme (EMAS).
15. Has the entity (voluntarily) published an environmental performance report? If so, has it been verified by an independent third party?
16. 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 impact the entity?
17. Does the entity have control procedures to deal with complaints about environmental matters, including health problems, from employees or third parties?
18. Does the entity operate control procedures for handling and disposal of hazardous waste, in compliance with legal requirements?
19. Are control procedures in place to identify and assess environmental hazards associated with the entity's products and services and the proper communication of information to customers about required preventive measures, if necessary?
20. Is management aware of the existence, and the potential impact on the entity's financial statements, of:

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- Any risk of 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
- Unresolved complaints about environmental matters from employees or third parties?



## Appendix 2

### **Substantive Procedures to Detect a Material Misstatement Due to Environmental Matters**

The purpose of this appendix is to provide examples of substantive procedures that an auditor may perform to detect a material misstatement due to environmental matters.

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. The procedures need to be tailored to fit the particular circumstances of each engagement. In some cases, the auditor may judge it unnecessary to perform any of these procedures.

It may be necessary for the auditor to consult an environmental expert when evaluating the results of substantive procedures with regard to environmental matters. The decision to involve an expert is a matter of professional judgment, governed by the circumstances and matters such as the technological situation, complexity and materiality of the items concerned.

#### **General**

##### *Documentary Review in General*

1. Consider minutes from board of directors' meetings, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.
2. Consider publicly available industry information to consider any existing or possible future environmental matters. Also consider general available media comment, if any.
3. Where available, consider:
  - Reports issued by environmental experts about the entity, such as site assessments or environmental impact studies;
  - Internal audit reports;
  - "Environmental audit" reports;
  - Reports on due diligence investigations;
  - Reports issued by and correspondence with regulatory agencies;
  - (Publicly available) registers or plans for the restoration of soil contamination;
  - Environmental performance reports issued by the entity;

- Correspondence with enforcement agencies; and
- Correspondence with the entity's lawyers.

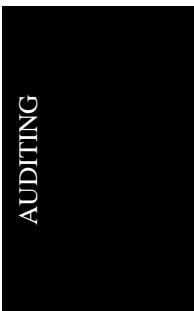
*Using the Work of Others*

4. If an environmental expert is involved (for example, an expert has quantified the nature and extent of contamination, considering alternative methods of site restoration) and the outcome has been recognized or disclosed in the financial statements:
  - (a) Consider the impact of the results of the expert's work on the financial statements;
  - (b) Assess the professional competence and the objectivity of the environmental expert;
  - (c) Obtain sufficient appropriate audit evidence that the scope of the work of the environmental expert is adequate for the purposes of the audit of the financial statements; and
  - (d) Assess the appropriateness of the expert's work as audit evidence.
5. If the internal auditor has addressed certain environmental aspects of the entity's operations as part of the internal audit, consider the appropriateness of the work of the internal auditors for the purpose of the audit of the financial statements, applying the criteria set out in ISA 610, "Considering the Work of Internal Auditing."
6. If an "environmental audit" has been performed and the findings of that audit could qualify as audit evidence in the audit of the financial statements:<sup>15</sup>
  - (a) Consider the impact of the results of the "environmental audit" on the financial statements;
  - (b) Assess the professional competence and the objectivity of the "environmental auditor"/audit team;
  - (c) Obtain sufficient appropriate audit evidence that the scope of "environmental audit" is adequate for the purposes of the audit of the financial statements; and
  - (d) Assess the appropriateness of the work of the "environmental auditor" as audit evidence.

*Insurance*

7. Inquire about existing (and earlier) insurance cover for environmental risk and discuss this with management.

<sup>15</sup> "Environmental Audit" see paragraph 45.



*Representations from Management*

8. Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:
  - (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 environmental matters that may result in a material impairment of assets; or
  - (c) If aware of such matters, has disclosed to the auditor all facts related to them.

*Subsidiaries*

9. Inquire of auditors of subsidiaries as to the subsidiary's compliance with relevant local environmental laws and regulations and their possible effects on their financial statements.

**Assets**

*Purchases of Land, Plant and Machinery*

10. For purchases of land, plant, and machinery made during the period (either directly by the entity, or indirectly through the acquisition of a subsidiary), inquire about the due diligence procedures management conducted to consider the effects of environmental matters in establishing a purchase price, taking into account the findings of remedial investigations and site restoration obligations.

*Long-term Investments*

11. Read, and discuss with those responsible, financial statements underlying long-term investments and consider the effect of any environmental matters discussed in these statements on the valuation of the investments.

*Asset Impairment*

12. Inquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy, assess their influences on the valuation of these assets or the company as a whole.
13. Inquire about policies and procedures to assess the need to write-down the carrying amount of an asset in situations where an asset impairment has occurred due to environmental matters.
14. Inquire about data gathered on which to base estimates and assumptions developed about the most likely outcome to determine the write-down due to the asset impairment.

15. Inspect the documentation supporting the amount of possible asset impairment and discuss such documentation with management.
16. 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.

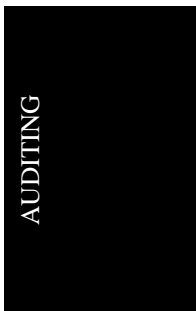
*Recoverability of Claims*

17. Review the recoverability of claims with respect to environmental matters that are included in the financial statements.

**Liabilities, Provisions and Contingencies**

*Completeness of Liabilities, Provisions and Contingencies*

18. Inquire about policies and procedures implemented to help identify liabilities, provisions or contingencies arising from environmental matters.
19. Inquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example:
  - Violations of environmental laws and regulations;
  - Citations or penalties arising from violations of environmental laws and regulations; or
  - Claims and possible claims for environmental damage.
20. If site clean-up costs, future removal or site restoration costs or penalties arising from noncompliance with environmental laws and regulations have been identified, inquire about any related claims or possible claims.
21. Inquire about, read, and evaluate correspondence from regulatory authorities relating to matters dealing with environmental matters and consider whether such correspondence indicates liabilities, provisions or contingencies.
22. For property abandoned, purchased, or closed during the period, inquire about requirements for site clean-up or intentions for future removal and site restoration.
23. For property sold during the period (and in prior periods), inquire about any liabilities relating to environmental matters retained by contract or by law.
24. Perform analytical procedures and consider, as far as practicable, the relationships between financial information and quantitative information included in the entity's environmental records (for example, the relationship between raw materials consumed or energy used, and waste production or emissions, taking into account the entity's liabilities for proper waste disposal or maximum emission levels).





*Accounting Estimates*

25. Review and test the process used by management to develop accounting estimates and disclosures:
  - (a) Consider the adequacy of the work performed by environmental experts engaged by management, if any, applying the criteria set out in ISA 620, "Using the Work of an Expert";
  - (b) Review the data gathered on which estimates have been based;
  - (c) Consider whether the data are relevant, reliable and sufficient for the purpose;
  - (d) Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data;
  - (e) Consider whether changes in the business or industry may cause other factors to become significant to the assumptions;
  - (f) Consider the need to engage an environmental expert regarding the review of certain assumptions;
  - (g) Test the calculations made by management to translate the assumptions into the accounting estimate; and
  - (h) Consider whether top-management has reviewed and approved material accounting estimates with respect to environmental matters.
26. If management's estimates are not appropriate, obtain an independent estimate to corroborate the reasonableness of management's estimate.
27. For liabilities, provisions, or contingencies related to environmental matters consider whether the assumptions underlying the estimates continue to be appropriate.
28. Compare estimates of liabilities relating to one location (for example, estimates for site restoration or future removal and site restoration costs at a specific location) with:
  - (a) Estimates of liabilities for other locations with similar environmental problems;
  - (b) Actual costs incurred for other similar locations; or
  - (c) Estimates of costs of environmental liabilities reflected in the sales price for similar locations sold during the period.

*Documentary Review*

29. Inspect and evaluate the documentation supporting the amount of the environmental liability, provision or contingency and discuss such documentation with those responsible for it, such as:
- Site clean-up or restoration studies;
  - Quotes obtained for site clean-up or future removal and site restoration costs; and
  - Correspondence with legal counsel as to the amount of a claim or the amount of penalties.

**Disclosure**

30. Review the adequacy of the disclosure of the effects of environmental matters on the financial statements.