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AUDITING PROCEDURES IN CONTEXT OF ASSIGNATION OF PRIORITY IN ENVIRONMENTAL AREA

Resumé

The aim of this article is to present a new approach to the environmental matter's assessment during the audit of financial statements. The authors of the article have considered the current legal regulations for auditor's activity, which have been fully compatible with the legal regulations for audits applied in the European Union since January 1, 2004. The importance of this article is not only in its , but mostly in the fact that it deals with issues, which become increasingly significant and important in these days – the environmental matters.

ACM classification

J.1 ADMINISTRATIVE DATA PROCESSING, *Financial*

JEL classification

M4 – Accounting and Auditing, M41 – Accounting, Q5 – Environmental Economics, Q56 – Environment and Development; Environment and Trade; Sustainability; Environmental Accounting; Environmental Equity; Population Growth

INTRODUCTION

The environmental issues are becoming more and more important for increasing number of entities, and in some cases they may have a significant impact on their financial statements. In a case where the environmental issues are significant for the entity, the auditor must consider all aspects relating to the environment at the audit of financial statements. Environmental matters can be complex, while the auditor's consideration should to be oriented mostly on:

- audit of financial statements with respect to environmental matters,
- examples of possible impacts of environmental matters on financial statements,
- 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:
 - knowledge of the business
 - risk assessments and internal control
 - consideration of laws and regulations
 - other substantive procedures

A) THE AUDITOR'S CONSIDERATION WITH RESPECT TO IMPACT OF ENVIRONMENTAL MATTERS ON ENTITY'S FINANCIAL STATEMENTS

The objective of an audit of financial statements is: „... to able the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.“

The auditor's interest object are the financial statements as a whole. In process of planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor must recognize, if non-compliance by the entity with laws and regulations may materially affect the financial statements. However, an audit can not be expected to detect non-compliance with all laws and regulations. In particular, with respect to the entity's compliance with environmental laws and regulations.

In process of preparing the overall audit plan, the auditor assesses inherent risk at the financial statements level. The consideration of environmental matters during the audit of financial statements depends on the auditor's judgment. The auditor should assess whether or not the environmental matters may have an impact on rising of risks of significant mistakes in the financial statements. In some cases the auditor may decide to a conclusion that any of special auditing procedures are not required. However, in other cases the auditor use 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.

Certainly, to express an opinion that the entity is 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.

B) ENVIRONMENTAL MATTERS AND THEIR IMPACT ON THE FINANCIAL STATEMENTS

„Environmental matters“ are defined as:

- 1) initiatives to prevent, decrease, 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),
- 2) consequences of violating environmental laws and regulations,
- 3) consequences of environmental damage done to others or to natural resources,

4) consequences of vicarious liability imposed by law (for example, liability for damage caused by previous owners).

In following text we present some examples of environmental matters affecting the financial statements:

- 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,
- 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, non-compliance 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.

To these day, there are only few authoritative standards, whether international or national standards, that explicitly address the recognition, measurement and disclosure of the consequences for the financial statements arising from environmental matters. For example, International Accounting Standard Nr. 10 „Contingencies and Events Occurring After the Balance Sheet Date“ presents the general considerations, which apply to the recognition and disclosure of contingent losses, including losses as a consequence of environmental matters.

C) GUIDANCE ON THE APPLICATION OF ENVIRONMENTAL MATTERS IN CONTEXT OF KNOWLEDGE OF THE BUSINESS

In obtaining a sufficient knowledge of the entity's business, the auditor considers important conditions affecting the entity's business and the industry in which it operates, such as environmental requirements and problems.

Usually 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 statement and on the audit. The auditor regards 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. These include the chemical, oil and gas, pharmaceutical, metallurgical, mining and utility industries. Of course, the 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,
- b) owns, or holds security over, sites contaminated by previous owners („vicarious liability“),
- c) has business processes that:
 - may cause contamination of soil and groundwater, contamination of surface water, or air pollution,
 - use dangerous substances,
 - generate or process hazardous waste,
 - may have an adverse impact on customers, employees, or people that live in the neighborhood of the company's sites.

D) GUIDANCE ON THE APPLICATION OF ENVIRONMENTAL MATTERS IN CONTEXT OF RISK ASSESSMENTS AND INTERNAL CONTROL

The application of certain aspects between environmental matters and the audit risk model, provide examples of the auditor's possible consideration of environmental matters with respect to the:

- inherent risk assessment,
- accounting and internal control systems,
- control environment,
- control procedures.

INHERENT RISK

The auditor uses professional judgment to evaluate the factors relevant to the assessment of inherent risk for the development of the overall audit plan. These factors may include the risk of material misstatement of the financial statements due to environmental matters.

We present examples of environmental risk at financial statements level:

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

If the auditor considers that environmental risk is significant 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.

We present examples of environmental risk at the level of account balances or classes of transaction:

- 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). In these cases provides guidance

to the auditors the auditor's standard - „Audit of Accounting Estimates“,

- the extent to which an account balance is affected by unusual or non-routine transactions involving environmental matters.

ACCOUNTING AND INTERNAL CONTROL SYSTEMS

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 is not important for the auditor. 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 (entity's „environmental control“). In these cases the auditor is only concerned with those environmental controls (within or outside the accounting and internal control system) that are considered relevant to the audit of the financial statements.

CONTROL ENVIRONMENT

The auditor should obtain an understanding of the control environment sufficient to assess management's attitude, awareness and actions regarding internal controls and their importance in the entity. 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, management's reaction to external influences such as those relating to monitoring and compliance requirements imposed by regulatory bodies and enforcement agencies,
- management's control system, including the internal auditing function, the performance of „environmental audits“.

CONTROL PROCEDURES

If the auditor comes to the conclusion that there is a need to obtain an understanding of environmental controls, he may proceed in this manner. Examples of control 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,
- identification of potential environmental matters and related contingencies affecting the entity.

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. 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.

E) GUIDANCE ON THE APPLICATION OF ENVIRONMENTAL MATTERS IN CONTEXT OF CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

It is management's assignment to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and

detection of non-compliance rests with management. 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 of 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,
- the requirements of regulatory authorities with respect to environmental matters.

Contingent and possible 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. The auditor in not, and cannot be held responsible for preventing non-compliance with environmental laws and regulations.

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. Non-compliance with these requirements might cause the entity to cease operations, or call into question the entity's continuance as a going concern,
- discusses with management the policies or procedures adopted for identifying evaluating and accounting for litigation, claims and assessments.

F) SUBSTANTIVE PROCEDURES

The auditor's assignment is to consider 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.

The assignment of the substantive procedures is obtaining and preparing 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.

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 (tests), either individually or in combination, are appropriate.

ENVIRONMENTAL EXPERT

Management is responsible for accounting estimates included in the financial statements. The management's assignment is to 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,
- gathering the necessary data on which to base estimates and providing details of information that needs to be disclosed in the financial statements,

- designing the appropriate remedial action plan and calculating related financial consequences .

The auditor may use the results of such work as part of the audit, but the auditor must consider 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 International Auditing Standard - "Using the work of an expert".

ENVIRONMENTAL AUDIT

The term „environmental audit“ has a wide variety of meanings. Environmental audit 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 audit. Often the work is performed by a multi-disciplinary team. Normally, environmental audit is performed at the request of management and is for internal use. It may address various subject matters. However, an environmental audit is not necessarily an equivalent to an audit of an environmental performance report.

The auditor, who verifies the financial statements, may consider using the findings of environmental audit as appropriate audit evidence. In that situation the auditor has to decide whether the environmental audit meets the evaluation criteria included in auditing standard - „Considering the work of internal audit“ or standard - „Using the work of an expert“. 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,
- e) the proper direction, supervision and review of the audit.

INTERNAL AUDIT

If the entity has an internal auditing section, 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 auditing standard - „Considering the work of internal audit“.

G) REPORTING

When forming an opinion on the financial statement, the auditor considers whether the effect of environmental matters is adequately treated or disclosed in accordance with the appropriate financial reporting standards. The auditor may conclude that there are significant uncertainties or inappropriate disclosures, due to environmental matters. They may even be circumstances when, in the auditor's judgment, the going concern assumption is no longer appropriate. The auditing standard „The Auditor's Report on Financial Statements“ and also standard „Going Concern“ provide detailed guidance to auditors in these circumstances.

CLOSURE

In this article the authors do not reserve the rights to establish new principles and procedures in area of environmental matters assessment during the audit of financial statements. The purpose of this article is to outline, present and primarily to help auditors in a development of their practice by providing for a certain framework (instructions) in dealing with environmental matters, which are significant with regard to the entity's financial statements. But it becomes obvious that the scope, in which auditor's procedures described in this article may apply to the particular cases, requires application of auditor's judgement based on legal requirements and applicable standards, and also considering of particular conditions at a particular entity.

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