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Environmental Issues in a Financial Audit:

Which Professional Standards Apply?

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Introduction

In recent years, environmental issues have become increasingly significant. Such issues concern environmentalists, wildlife specialists, and foresters, among others. Even independent auditors of financial statements are concerned with environmental issues.

The financial auditor's concern with environmental issues arises because of the need for appropriate accounting for the financial aspects. Environmental problems may result in contingent losses. Such losses must be appropriately reflected in the financial statements.

Several statements on auditing standards (SASs) and a statement on financial accounting standards (SFAS) provide guidance to the external auditor planning an engagement which may involve environmental issues. The relevant standards include those related to contingencies, illegal acts, the use of specialists, the internal control structure and reportable conditions, and accounting estimates. Several other SASs may also have some bearing on a financial audit with environmental issues.

This article briefly discusses the legislation which created liability for environmental problems and reviews the accounting principles for contingencies. The focus of the article is on the auditing standards which apply to environmental concerns on a financial statement audit. This article discusses environmental issues as they relate to financial statement audits by external auditors; it does not deal with an audit in which the objective is to address environmental issues (an environmental or green audit).

Superfund and SFAS 5

Superfund

Congress passed the Comprehensive Environmental Response, Compensation, and Liability Act in 1980. The act is widely known as "Superfund" because of its provisions to establish funds for both cleanup of hazardous waste sites and for care of the sites after closure. However, the focus of the act is on legal exposures.

Superfund discusses two legal exposures. The first requires that the government be notified of the release of hazardous wastes and the location of the release. The second deals with the liabilities associated with the release of hazardous substances. Criminal sanctions apply to the party who knowingly fails to notify the government of the release of hazardous substances, while civil liabilities accrue to the party who releases hazardous substances. Releases may be into water (surface water or groundwater), air, land, or subsurface strata.

Hazardous substances is a term which is broader than hazardous waste, yet narrower than the terms pollutant or contaminant. Federal laws cite about 700 substances which are deemed hazardous.

Parties in charge of a facility at which a hazardous substance is located and who have knowledge that the substance is present (in greater than specified levels) must notify the National Response Center. Failure to do so may result in fines and/or imprisonment. A facility includes a site, a landfill, a vehicle, a building, and a pipe.

Four groups are potentially liable for damages from the release of a hazardous substance. They are:

(1) the owner or operator of the vessel or facility,

(2) the party who owned or operated the facility at the time of the disposal,

(3) the party who arranged for the disposal or treatment of the hazardous substance or its transporting, and

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(4) the transporter of the hazardous substance.

Under the theory of joint and several liability, the government can pursue any of these groups for the entire cost of cleanup. Regardless of the proportion the party contributed to the problem, the party may be ordered to pay for the entire cleanup.

The government can recover costs which are actually incurred for cleanup. The costs must be consistent with the National Contingency Plan, which requires that the costs be incurred in a cost-effective manner after evaluation of all possible alternatives.

Punitive damages and daily fines may be ordered

Other costs may be assessed if the government believes there is a threat of imminent danger to human health or the environment. Daily fines may be assessed and punitive damages up to three times the actual cost of cleanup may be ordered.

SFAS 5

Statement on Financial Accounting Standards 5 (SFAS 5), "Accounting for Contingencies", is the authoritative pronouncement most applicable to the accounting for environmental costs.

SFAS 5 defines a contingency as:

> an existing condition, situation, or set of circumstances involving uncertainty as to possible...loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur. Resolution of the uncertainty may confirm...the loss of impairment of an asset or the incurrence of a liability (FASB, 1975).

SFAS 5 also defines gain contingencies. The discussion here is limited to loss contingencies.

When considering a possible loss contingency, the accountant determines the likelihood that a future event will confirm the impairment of an asset or the incurrence of a liability. SFAS 5 categorizes the likelihoods into three levels: probable, possible, and remote.

The accounting treatment of a loss contingency depends on the likelihood of loss and, in some cases, on the ability of the client to estimate the loss. The possible accounting treatments for a loss contingency are accrual of an appropriate amount, disclosure through the footnotes, or no recognition in the financial statements.

If the likelihood of a contingency resulting in a loss is remote, no accounting treatment is necessary.

If it is probable that a contingency will result in a loss and the loss can be reasonably estimated, the loss is accrued.

Disclosure is required in three situations. First, if the likelihood of loss from the contingency is probable, but a reasonable estimate of the amounts cannot be made, the contingency is disclosed. Second, if the contingency is possible, disclosure is called for. Finally, disclosure is made of a loss contingency arising after the balance sheet date which is either possible or probable.

Illegal Acts

SAS 54, "Illegal Acts by Clients" (AICPA, 1988), provides guidance to the auditor considering environmental transactions or situations which may be violations of rules, regulations, or laws. The Standard aids the auditor who is considering the possibility of environmental illegal acts by defining the auditor's responsibility with respect to such occurrences.

SAS 54 requires the auditor to design the audit to provide reasonable assurance of detecting illegal acts which have a direct and material effect on the financial statements. Other acts may not have a direct effect; the effect may be indirect. That is, some laws and regulations relate primarily to operations, rather than to financial and accounting aspects of the client.

Environmental laws and regulations are among those which may have an indirect impact on the financial statements. The effect is not direct because environmental issues do not directly affect the financial and accounting areas of the firm. The indirect effect arises from the possibility of a contingent liability. The contingency may have to be accrued or disclosed, as required by SFAS 5.

The auditor is not required to search specifically for violations of environmental laws. Rather, procedures, such as making enquiries of management and attorneys, reading the minutes, and performing substantive tests, which are performed as a normal part of the audit, may reveal environmental violations. For example, audit procedures may uncover investigations by the EPA or other government environmental agencies, reports by governmental agencies noting violations, or payments of fines.

If the possibility of an environmental violation comes to the auditor's attention, an investigation should be

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undertaken to ascertain if an illegal act has occurred. The nature of the act should be understood, as well as the circumstances under which it occurred. Additional audit procedures may be necesary. For example, tests may be performed to ascertain if other, similar acts have taken place. These procedures help the auditor understand the potential impact on the financial statements.

The possible monetary effect of an environmental violation might take many forms. The client could be fined. Penalties may be imposed. Damages could be assessed. A facility might be shut down, resulting in loss of income. Litigation could occur, imposing a drain on both the resources and energy of the client. If any of these possible monetary effects could be material, the auditor must ascertain that the event has been treated as a loss contingency and accrued or disclosed as appropriate.

The audit report may be affected by an illegal act

Besides loss contingencies, the auditor should also consider the implications a possible environmental illegal act might have on other aspects of the audit. For example, if management not only allowed an environmental illegal act to occur, but also attempted to conceal the information from the auditors, the reliability of management representations in other areas of the engagement may be questionable.

The audit report may be affected by an illegal act involving an environmental concern. If the auditor can gather appropriate evidence about the event but the client has not accrued the amount or disclosed the situation, a departure from generally accepted accounting principles (GAAP) exists. Depending on the materiality of the situation, the auditor must qualify the opinion or give an adverse opinion for a departure from GAAP. If the auditor is precluded from gathering sufficient, competent evidence, there is a scope limitation. A scope limitation arising from the client's unwillingness to supply information normally calls for a disclaimer of opinion. If the scope limitation is beyond the client's control, the auditor should consider the significance of the limitation. Either a qualified opinion or a disclaimer of opinion is appropriate, depending on the materiality of the scope limitation.

Environmental Specialists

The auditing standards recognize that auditors are not expected to have expertise in fields besides accounting and auditing. There are instances in which the auditor consults with specialists in other areas. For example, in an audit of a client with possible environmental violations, the auditor may utilize the work of an environmental specialist or consultant. The auditor's use of a specialist is the topic of SAS 11, ''Using the Work of a Specialist'' (AICPA, 1975).

If an environmental problem arises on an engagement, there are many questions which the auditor needs to answer in order to assess the likelihood and materiality of a contingency. An environmental consultant can aid the auditor by addressing questions relating to which laws and regulations apply to the client, what factors may indicate a potential violation, what actions the client is taking to rectify the situation, and proactive activities. Figure 1

Figure 1. *Questions to Ask an Environmental Specialist*

Identifying applicable laws

- Which governmental agencies have jurisdiction over environmental matters for this client?
- Which environmental laws and regulations impact on this client?

Identifying possible environmental violations

- What conditions exist that may indicate an environmental violation has occurred?
- What are the probabilities that an environmental violation occurred?

Possible environmental violations

- What methods are available for cleanup and remedial action?
- What is the estimated cost of cleanup and remedial action?
- How long will the cleanup and remedial action take?
- What is the likelihood that the client will be assessed fines, penalties, or damages?
- What is the likelihood that the client's operations will be shut down?
- What amounts might be involved in fines, penalties, or damages?
- What is the loss of income from shutting down operations?
- What steps is the client taking to ensure that such a violation does not recur?

Proactive activities

- How can the client be proactive in addressing environmental issues?

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presents questions which the auditor should consider having the specialist address.

In selecting an environmental consultant, the auditor assesses the professional's qualifications and reputation. Professional licensure and certification should be considered. A consultant unrelated to the client provides evidence with greater reliability than one with ties to the client.

Before the environmental consultant begins work, the client, the auditor, and the specialist should reach an agreement as to the work to be performed. The agreement, preferably in writing, should include the objectives and scope of the consultant's work, the methods and assumptions to be used, the planned form and content of the consultant's report, and the use of the report.

The Internal Control Structure

In performing a financial statement audit, the auditor is required by SAS 55, "Consideration of the Internal Control Structure in a Financial Statement Audit" (AICPA, 1988), to understand the internal control structure. Environmental issues can play a significant role in this.

The internal control structure is composed of three elements: the control environment, the accounting system, and control procedures. To understand the internal control structure, the auditor must understand each of its three elements.

The control environment encompasses management's philosophy and operating style, management's methods for monitoring and following up on performance, and external influences, such as laws and regulations. Thus, management's attitude towards environmental issues, how environmental concerns are identified and monitored, and how relevant environmental laws and regulations impact on the auditor's assessment of the control environment.

The accounting system is the process of capturing and recording transactions and events, including those which are environmentally related. The auditor must understand how environmental transactions and events are identified and recorded in the accounting records (whether by accrual, footnote disclosure, or no treatment).

Control procedures are policies and procedures which management has established to ensure that specific entity objectives are achieved. The client should have such policies and procedures in place to ensure that the entity is in compliance with environmental laws and regulations. Other policies and procedures should be established addressing the course of action if violations should occur.

After understanding the control structure, the auditor assesses control risk. Adequate or good controls over environmental issues may aid the auditor in assessing control risk below its maximum level. For example, the auditor may find that the board of directors and management are concerned with environmental matters and that the client has a proactive attitude towards environmental issues. Also, an accounting committee meets on a monthly basis to determine the appropriate accounting treatment of environmental transactions, and policies are in place to identify environmental transactions.

In this situation, the auditor may be able to place some reliance on the control structure and assess control risk below its maximum level. The need for evidence from later substantive tests is then reduced.

Reportable Conditions

During the course of performing work on internal control, the auditor may become aware of reportable conditions which relate to environmental issues. Reportable conditions are "significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data. (Paragraph 2, SAS 60, "Communication of Internal Control Structure Related Matters Noted in an Audit", AICPA, 1988). For example, the auditor may discover that the client's control structure, designed to detect environmental problems, failed to note a significant violation. Alternatively, the auditor may find that the client, a firm which disposes of waste in a landfill, does not have in place any system to detect adverse environmental transactions or events. The auditor would likely deem either of these examples to be reportable conditions. The situations might also be considered material weaknesses in internal control.

A material weakness is a serious form of reportable condition in which the internal control structure does not reduce to a low level the risk that material misstatements will occur and not be detected. The auditor may determine that reportable conditions related to environmental issues may be of such a magnitude as to be considered material weaknesses.

The auditor is not required to search for reportable conditions. However, if an environmentally related reportable condition is found, it must be reported to the audit committee. Preferably, the report is made in writing; an oral report is allowed. Normally, the communication occurs at the conclusion of the engagement. However, if timely action is warranted, as could the case for an environmental issue, the auditor may make the report during the course of the engagement.

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The auditor is allowed to report environmental concerns to the client which are not serious enough to be categorized as reportable conditions. In fact, the client may request that procedures addressing environmental issues, beyond those necessary for the financial audit, be performed. Findings from these additional procedures may be included in the communication of reportable conditions, but should be clearly distinguished from the conditions.

The distribution of the report on reportable conditions is restricted. The report is intended for use by the audit committee, management, and other parties within the organization. At times, regulatory agencies, including those with jurisdication over environmental matters, may require a copy of the report. In such a case, the auditor makes specific reference to the agency in the report.

Accounting Estimates

The guidance of SAS 57, "Auditing Accounting Estimates" (AICPA, 1988), should be considered when the client has developed (or should develop) an estimate of an environmental liability. The SAS emphasizes that management is responsible for developing the estimate; the auditor's duty is to determine its reasonableness.

Management bases the estimate of environmental costs on assumptions and the course of action it expects to take. For example, the client may have received notice from the EPA that it is in violation of regulations concerning smoke emissions. The client plans to modify the equipment to bring the emissions within acceptable limits. Management should identify relevant factors which may affect the estimate and gather data on which to base it. The cost of modification should then be estimated and accrued.

The auditor has three objectives when considering environmental estimates. First, the auditor would like to ascertain that all necessary material environmental estimates have been developed. Also, the auditor should determine that the estimates are reasonable. Finally, the presentation and disclosure of environmental estimates should be appropriate.

To address the first objective, the auditor makes enquiries of management and outside legal counsel concerning environmental matters. Regulatory agency reports are reviewed, as are the minutes of shareholders and board of directors meetings.

To determine the reasonableness of an environmental estimate, the auditor may use one or more approaches. The auditor may independently develop an estimate of the environmental loss and compare the expectation with the client's estimate. Another approach is to review and test the process which management uses to develop its estimate. Finally, events subsequent to the date of the financial statements but before the issuance of the auditor's report may impact on the environmental estimate.

In reviewing the appropriateness of presentation and disclosure, the auditor should consider the guidance in SFAS 5 (discussed earlier), regarding the likelihood of the loss contingency and the ability to estimate the amount. Disclosure or accrual is required, unless there is only a remote chance that the contingency will result in a loss.

Other Standards

Several other SASs are relevant to the financial audit in which environmental contingencies may be present. Standards dealing with the client representation letter, the lawyer's letter, going concern, the audit report, and communications with audit committees are discussed below.

Client Representation Letter

The auditor is required by SAS 19, "Client Representations" (AICPA, 1977), to obtain a client representation letter. An unqualified opinion may not be given if the letter is not obtained.

The auditor should consider discussing environmental issues in the representation letter. For example, if the auditor discovered violations of environmental regulations, these should be included in the letter. The current status of actions taken by the client or regulatory agencies should also be noted. Other environmental issues which the auditor should consider including in the client representation letter are presented in Table I.

Table I. *Environmental Issues to be Included in the Client Representation Letter*

Communications with regulatory agencies regarding environmental issues
Violations or possible violations of environmental laws or regulations
Subsequent events relating to environmental matters
Environmental loss contingencies
Unasserted environmental claims or assessments which the attorney believes are probable of assertion.
Management's responsibility for developing estimates of environmental costs
Non-compliance with contracts which have environmental effects
Management's responsibility for the financial statements (which may include environmental expenses and accruals)

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Lawyer's Letter

Per SAS 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments" (AICPA, 1976), the auditor must inquire of the client's attorney regarding litigation, claims, and assessments against the client, including those of an environmental nature. Management should initially inform the auditor about significant legal matters related to environmental issues; the communication with the attorney should merely be used to corroborate information already known by the auditor.

Before communicating with the attorney, the auditor performs procedures regarding legal matters with environmental ramifications. Enquiries should be made as to how management identifies legal claims. Management's evaluation of current legal matters should be reviewed. Documents related to environmental violations should be examined. Also, the auditor should request that management provide assurance that it has disclosed all unasserted environmental violations that the attorney believes are probable of assertion. Finally, the minutes of board meetings and stockholders' meetings, contracts, and correspondence with governmental agencies should be reviewed to ascertain if possible environmental violations exist.

After discovering as much as possible concerning environmental legal matters from the client, the auditor communicates with the client's attorney. The communication is normally in writing. The auditor requests the attorney to comment on asserted, as well as unasserted, claims. Counsel should describe the nature of the claim, the progress made, and what action the client intends to take. Also, the likelihood of an unfavourable outcome and the range of potential loss should be discussed. This information helps the auditor determine the appropriate accounting treatment for the loss contingency.

Going Concern

There are instances in which environmental violations may actually threaten the client's viability as a going concern. For example, a chemical company, after numerous warnings and fines, continues to dispense hazardous materials into a lake adjoining a national park. The auditor should consider the likelihood that a governmental agency could order the facility to be shut down.

SAS 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AICPA, 1988), provides guidance to the auditor regarding the going concern status of the client. The Standard requires that, on every audit, the auditor consider whether the entity will continue as a going concern for a period of one year from the balance sheet date. The auditor examines negative evidence, such as violations of environmental regulations, in assessing going concern. Positive information, such as the hiring of a specialist to develop an environmental plan, is also considered. The auditor judgementally weighs the evidence in making a going concern decision.

If the auditor believes that substantial doubt exists about the going concern status of the client, the audit report must be modified. An explanatory paragraph is added to the report, noting the environmental problems. If management has discussed the situation in a footnote to the financial statements, the audit report may refer the reader to that footnote.

Audit Report

The auditor has several options when issuing an audit report for a financial audit in which environmental concerns were noted.

If the auditor was able to follow generally accepted auditing standards (GAAS) and there are no material departures from GAAP in the financial statements, the standard three paragraph report may be issued. That is, assuming the auditor was able to apply the procedures considered necessary and the accrual or disclosure was appropriate, a "clean opinon" could be given for an audit in which environmental violations were noted. However, the auditor should keep in mind that an explanatory paragraph, used to emphasize a matter, can be added to the standard report. The opinion is still unqualified; the explanatory paragraph allows the auditor to emphasize to the reader the occurrence of environmental transactions.

If the scope of the engagement was limited, the audit report might be a qualified opinion or a disclaimer of opinion. For example, if the auditor was not able to gather adequate information to test the estimate of the environmental liability, the report would probably be amended.

A departure from GAAP problems related to environmental issues may also cause the audit report to be modified. For example, the auditor may believe the estimate of the environmental liability is inappropriate or that disclosure of environmental issues is not adequate. Depending on the materiality of the amounts involved, the auditor may qualify the opinion or give an adverse opinion.

Communications with the Audit Committee

As discussed earlier, the auditor is required to communicate with the audit committee concerning reportable conditions. SAS 61, "Communication with Audit Committees" (AICPA, 1988), notes that the auditor should communicate with the committee about several other topics as well.

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The audit committee should be informed of significant accounting policies, including those related to environmental costs. For example, the auditor should discuss with the audit committee how environmental issues are identified, how related costs are accumulated (or estimated), and how the amounts are reflected in the financial statements.

If the client experienced environmental transactions, management may have developed estimates of the costs involved. The auditor should explain management's process of formulating the estimates and discuss the auditor's beliefs concerning the reasonableness of the amounts with the audit committee. (See the earlier discussion on accounting estimates.)

The audit committee should also be informed about significant audit adjustments for environmental problems and disagreements with management regarding environmental issues. Audit adjustments should be reported, regardless of whether management agreed to book the proposed entry or not, because the adjustments reflect corrections which may not have been detected by the client's system. Disagreements may arise between management and the auditors concerning accounting estimates, the scope of the engagement, the application of accounting principles, the wording of the report, or other matters. Such issues should be discussed with the audit committee, so that it has a better understanding of management's and the auditor's positions.

The communication with the audit committee may be in writing or may be made orally. An oral presentation may allow the members of the audit committee the opportunity to ask questions and clarify difficult points. It is advisable to follow up oral communications with written documentation as to what was discussed.

Conclusion

An auditor preforming a financial statement audit may encounter transactions or events with environmental implications. Although the financial effect of environmental issues may be indirect, the amounts may be material. The auditor must be alert to the possibility of loss contingencies and must ascertain if the contingencies are accounted for properly. Auditing standards on illegal acts, the use of specialists, the internal control structure and reportable conditions, and accounting estimates are particularly relevant to auditing environmental costs. Other SASs, especially those dealing with the client representation letter, the attorney's letter, the going concern status of the client, the audit report, and communications with the audit committee, may also provide helpful guidance to the auditor. Ultimately, however, the decision as to the appropriateness of the client's accounting for environmental costs depends on the auditor's professional judgement.

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