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NEW LEGAL PERSPECTIVES ON ENVIRONMENTAL AUDITING SERVICES

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ISSUES CEAA ASKED ME TO ADDRESS

"Audits have traditionally been a means of verifying performance and providing assurance on issues to management.

With greater emphasis on due diligence and corporate governance

- **Is there a need for a shift in how auditors contribute?**
- **Should there be any changes in the role audits play?**
- **If so, what are the changes required?**
- **Does the relationship between auditors and the management and Boards of Directors need to be reviewed and reconsidered, or do current principles and practices satisfactorily address what is required?"**

Past (and continuing) Motivations for Environmental Audits – To Avoid Environmental Liability

- **Environmental audits were in part originally motivated by the view of corporate executives and their legal advisors that carrying them out would help to demonstrate legal due diligence – in other words environmental audits could be central to preventing corporate executives from going to jail for pollution, and keeping the corporation from being convicted of environmental neglect.**

- **Environmental audits were also seen as part of a larger management tool, an environmental management system as envisioned by, e.g., the ISO 14000 standards.**

Legal Due Diligence Defined

- ***Sault Ste Marie*(1978):**

  A defendant can avoid conviction by proving all due care has been taken to avoid the environmental offence

- ***Bata* (1992):**

  In assessing due diligence a court will ask:

-did the board establish a pollution prevention "system"?

-was there supervision and inspection?

-was there improvement in business methods?

-did each director ensure that officers were instructed to set up a system sufficient within the industry of ensuring compliance, to report back to the board on the system operation and to ensure officers are instructed to report any substantial non-compliance?

Legal Due Diligence Defined

- Did the system include contingency and remedial plans for spills, an on-going system of environmental audit, training programs, sufficient authority to act and indices of a pro-active environmental policy?

- *Imperial Oil* (2000):

  EMS may not be enough - the corporation must show it took care to prevent the specific risk that led to the charge.

Pre-Sox U.S. Corporate Environmental Disclosure Requirements

- **SEC Registration statements or stock offering and other reports required disclosure of "material" information associated with the company's compliance with environmental laws, such as**

  - **Material effects of environmental compliance on earnings, competition and capital expenditures**

  - **Known environmental trends, events or uncertainties that are reasonably likely to have a material effect on the liquidity, capital resources or operating results**

  - **Material environmental proceedings and litigation. "Material" information is that "to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the security registered."**

and….

Pre-Sox U.S. Corporate Environmental Disclosure Requirements (cont'd)

- **Known and contingent losses relating to environmental matters**

- **Any "material" administrative or judicial proceeding under federal, state or local environmental laws – it being "material" if it involves a claim for damages or potential monetary sanctions, capital expenditure and/or deferred charges which exceed or are likely to exceed 10% of the company assets.**

New Requirements for More Detailed and Responsible Corporate Governance

Background to recent U.S. (and Canadian) Initiatives

- Fall-out of accounting scandals such as Enron, Arthur Anderson and several other companies in U.S. led to the Sarbanes-Oxley Act (SOX) of July 30, 2002

  Canadian corporate problems: Bre-X, Cinar, Livent, Phillip Services, YBM

- These demonstrated companies could significantly misstate net earning and net asset positions, corporate board and audit committee were inattentive to such practices, and that so-called “independent” auditing firms were signing off on such practices.

New Requirements for More Detailed and Responsible Corporate Governance

- **The new watchwords:**
- **i. Transparency (i.e. full and frank disclosure of risks)**
- **ii. Independence (e.g. of auditors, boards and audit committee)**
- **iii. Accountability (e.g. CEO, CFO and audit committee)**

New Requirements for More Detailed and Responsible Corporate Governance -- SOX

SOX

i. Requires auditor independence, i.e., no contemporaneous consulting services by auditing firm during the audit , e.g. expert services unrelated to the audit

ii. Establishes Accounting Oversight Board for auditors carrying out audits of publicly held companies

iii. Imposes significant CEO and CFO personal responsibility – and liability – for financial reports

iv. Requires broader consideration of facts and events than GAAP

v. Requires much improved internal control systems to ensure material information is brought to attention of senior management

vi. Provides that members of the board audit committee all be outside directors, i.e. not part of management

vii. Prohibits officers and directors from seeking to improperly influence, or manipulate or mislead financial auditors

Canadian Developments – What are the Right Standards for Audits?

- ***Kripps v. Touche Ross & Co*, 1997 B.C. Court of Appeal decision**

Background

- **An action by debenture holders who purchased on basis of an annual prospectus containing financial statements of the company's auditors**

- **Company failed; plaintiffs claimed report was a negligent misrepresentation as the financial statements had not accurately reflected the company's position, including an inadequate provision for future losses, failure to disclose transactions with a related company and failure to disclose the amounts of loans and unpaid interest in arrears**

Industry Standards Do Not = Legal Standard of Care

- **Auditor's report stated that the financial statement fairly represented the Co. position using GAAP, the standards used by the CICA**

- **Trial judge dismissed the action, in part on the basis that GAAP did not require disclosure of defaulted mortgage loans and so the defendant had met the requisite standard of care**

- **Court of Appeal found the accounting firm liable, ruling that standards of professional bodies cannot supplant degree of care called for by law**

Court of Appeal excerpts on Auditing Standard of Care

- **"…the aim of an auditor's report is to allow auditors to provide their professional opinion which may be relied upon as a guide to business planning and investment. GAAP may be their guide to forming their opinion, but auditors are retained to form an opinion on the fairness of the financial statements, not merely on their conformity to GAAP."**

- **"Given the aim in auditing, the understanding of audits that those who might rely on them have, and that auditors know of this understanding, auditors cannot hide behind the qualification to their reports ("according to GAAP") where the financial statements nevertheless misrepresent the financial position of the company."**

Auditors Following "Standard Practice" can be Negligent

- **"If a standard practice fails to adopt obvious and reasonable precautions which are readily apparent to [a judge], then it is no excuse for a practitioner [e.g. an auditor] to claim that he or she was merely conforming to such a negligent common practice."**

- **"While deference will be shown to the professional standard, the court will not blindly accept it…."**

- **"A professional body cannot bind the rest of the community by the standard it sets for its members. Otherwise all professionals could immunize their members from claims of negligence."**

New Corporate Standards -- AUDIT COMMITTEE AUTHORITY – MI 51-110

Independent Directors' Audit Committee must exist and

- **be directly responsible for overseeing the work of the external auditor engaged for the purpose of preparing or issuing an auditor's report or performing other audit, review or attest services for the issuer, <u>including the resolution of disagreements between management and the external auditor regarding financial reporting.</u>**

- **review the issuer's financial statements, MD&A and annual and interim earnings press releases before the issuer publicly discloses this information.**

- **be satisfied that adequate procedures are in place for the review of the issuer's public disclosure of financial information extracted or derived from the issuer's financial statements, other than the public disclosure referred to in subsection (5), and must periodically assess the adequacy of those procedures**

AUDIT COMMITTEES

The Audit Committee must have the authority to

(a) engage independent counsel and other advisors as it determines necessary to carry out its duties,

(b) set and pay the compensation for any advisors employed by the audit committee, and

(c) communicate directly with the internal and external auditors.

OVERSIGHT OF AUDITORS – MI 52-108

Requires public accounting firms auditing reporting issuers to

- participate in the Canadian Public Accountability Board oversight program
- be in compliance with any sanctions or restrictions imposed by CPAB

Other Recent Actions by Canadian Securities Regulators – BETTER DISCLOSURE

Multilateral Instrument 52-109 – Certification of Disclosure in Issuer's Annual and Interim Filings*

- **Requires annual and interim certificate filings signed by CEO and CFO regarding corporate financial and other disclosure.**

- **Certification must state that information in the filings "present fairly" in all material respects the "financial condition" for the applicable period.**

"Fair presentation" is not defined but the Companion Policy states it is not limited to compliance with GAAP applicable to the issuer and requires that the CEO and CFO adopt a broader standard of "overall accuracy and completeness" than under GAAP.

*In force since March 30, 2004 in every Canadian jurisdiction except B.C.

FAIR DISCLOSURE FURTHER DEFINED

"Fair presentation" requires, in addition to selection of appropriate accounting policies, their proper application and disclosure of financial information that is "informative", the "inclusion of additional disclosure necessary to provide investors with a materially accurate and complete picture of financial condition...."

"Financial Condition" is not defined, but the Companion Policy states it is to be used in the same manner as in the CICA MD&A Guidelines, i.e. "financial condition" encompasses a number of "qualitative and quantitative factors", which include liquidity, solvency, capital resources, overall financial health of the business and

" current and future considerations, events, risks or uncertainties that might affect the financial health of the business."

Management's Discussion & Analysis (MD&A) Requirements – Form 51-102f1

Pursuant to another new securities disclosure requirement, subject corporations must regularly file a MD&A.

An MD&A is explained as follows:

MD&A is a narrative explanation, through the eyes of management, of how your company performed during the period covered by the financial statements, and of your company's financial condition and future prospects. MD&A complements and supplements your financial statements, but does not form part of your financial statements.

Your objective when preparing the MD&A should be to improve your company's overall financial disclosure by giving a balanced discussion of your company's results of operations and financial condition including, without limitation, such considerations as liquidity and capital resources - openly reporting bad news as well as good news.

Your MD&A should

- help current and prospective investors understand what the financial statements show and do not show;
- discuss material information that may not be fully reflected in the financial statements, such as contingent liabilities, defaults under debt, off- balance sheet financing arrangements, or other contractual obligations;
- discuss important trends and risks that have affected the financial statements, and trends and risks that are reasonably likely to affect them in the future; and
- provide information about the quality, and potential variability, of your company's earnings and cash flow, to assist investors in determining if past performance is indicative of future performance."

An MD&A Requires Forward-Looking Information

"You are encouraged to provide forward-looking information if you have a reasonable basis for making the statements. Preparing your MD&A necessarily involves some degree of prediction or projection. For example, MD&A requires a discussion of known trends or uncertainties that are reasonably likely to affect your company's business. However, MD&A does not require that your company provide a detailed forecast of future revenues, income or loss or other information."

Environmental Audit Implications of Securities Certification Requirements on CEOs/CFOs

- **The Securities Certification requirements brings into Canada the pre-SOX environmental disclosure requirements established by the SEC (see prior slides)**

- **<u>Implications for the CEO/CFO/Audit Committee</u>**

  In our opinion there is a legal responsibility on the CEOCFO/Audit Committee to engage independent environmental auditors to ensure consideration and reporting of environmental issues which "might" affect the company's financial health and which are therefore required to be appraised and disclosed, particularly…

Environmental Audit Implications of Securities Certification Requirements on CEOs/CFOs

where

i) a corporation is or has engaged in activities which create contaminants, or there is any other credible basis for a CEO/CFO to believe that the company or the lands on which it is operating or has owned has potential past, current or future environmental liabilities, (e.g. waste);

ii) new legislation creates potential future liabilities (e.g. Kyoto implementation); or

iii) there are continuing environmental liabilities, such as tailing or sewage ponds, underground tanks, on-going discharges, etc.

Environmental Audit Requirements & CFO Due Diligence

A further reason to include Environmental Audits in Corporate Disclosure – CEO Due Diligence

The *Ontario Securities Act* provides that the CEO/CFO who makes a certification statement that is in a material respect and at the time and in the circumstances it was made misleading or untrue, or who does not state a fact required to be stated or that is necessary to make the statement not misleading, is subject to:

- **Prosecution, and on conviction liable to a fine up to $5 million or to imprisonment for up to 5 years, or both**

Environmental Audit Implications of Securities Certification Requirements

- a Securities Commission order requiring that they resign as a director or officer and/or be prohibited from becoming or acting as a director or officer for any issuer. No violation of securities law needs be proved; the Commission needs only to form the opinion it would be in the public interest to make such an order

- a Securities Commission administrative penalty of up to $1 million for each contravention

- a statutory civil action for damages by wronged investors.

Implications of Recent Judicial and Security Regulators Initiatives for Environmental Auditors

What would happen if an environmental auditor missed or understated a material environmental problem, affecting its financial health?

The B.C. *Kripps vs Touche Ross* case decides that disgruntled investors can successfully sue auditors who did not appropriately identify, articulate and clearly warn of the potential problem. This reasoning should equally apply to environmental auditors.

***Kripps vs. Touche Ross* further suggests that whatever are the accepted standards of auditing, it remains for a judge to determine if they were reasonable in light of the tools available and the potential risks if an inadequate investigation or analysis is made. <u>This suggests that environmental auditors must carefully consider whether the usual environmental auditing standards are appropriate in a particular case.</u>**

Implications for Environmental Auditors

To protect yourselves from future liability to shareholders, officers and directors, environmental auditors should be

- **reviewing standard approaches - you need to be proactive in ensuring that the scope of approach allows for identification of situations which may be within the provisions of the new reporting requirements**

- **informing senior management and/or the audit committee if you believe further investigations, analysis and reporting may be required beyond your initial retainer.**

Implications for Environmental Auditors

Because, however, this is obviously a sensitive matter, the CEAA may wish to set up a process for dialogue with Securities Administrators, the CICA and the new Canadian Public Accountability Board as to appropriate courses of action if no instructions or inadequate budgets are provided for environmental audits in situations where there is a reasonable basis to believe investigations are required for these corporations to carry out their mandatory disclosure requirements.

Conclusions *

- **Recent developments in financial reporting requirements for issuing companies should require more frequent, regular and in-depth examination of environmental conditions.**

- **There is likely to be an increasing role for in-house environmental managers to ensure a reliable flow of environmental auditing information to top management and the Board.**

- **Corporate management will be increasingly reliant on environmental auditors for information regarding situations which may be material to the company's financial picture. This will extend to matters of risk identification and evaluation for "forward-looking" statements required to be made in the MD&A portion of reports to be filed with securities commissions.**

…cont'd

Conclusions *

- **The new requirements re auditor objectivity and the avoidance of even apparent conflicts of interest may well be applied by analogy by corporate managers in the selection of environmental auditing firms.**

- **In-house environmental auditing, while not inappropriate for carrying out environmental management system objectives, would almost certainly not be acceptable as "independent" under the new regime.**

- **Directors and officers have new incentives, and indeed legal requirements, to ensure environmental risks are properly assessed and disclosed.**

- **The recent regulatory scheme should make environmental auditors a more regular and important component of corporate due diligence and financial analysis.**

* Several of these predictions originated in Ridgway M. Hall, Jr.'s paper delivered to The Auditing Roundtable Spring Meeting, Montreal, March, 2004

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