AUSTRALIAN NATIONAL AUDIT OFFICE

Sustainability Reporting – The Role of Auditors

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1. Introduction

I appreciate the opportunity to make the lead address at this conference on the role of auditors in sustainability reporting.

Sustainability reporting is a relatively new topic to the public sector, but one that is rapidly increasing in discussions, if not in actual practice. Sustainability reporting has now been part of private sector reporting for well over a decade, particularly in the resources industries. Shareholder oriented groups have also been increasingly active in both their demands for such information and in their investment preferences for organisations that are performing well in these regards. The following observation is apposite:

> *The business community increasingly understands that organisations that record and report sustainability information are well managed, with a full picture of the health of their entire operations at their fingertips. This in turn has led to an increased demand for independent review and audit of sustainability reports from companies seeking greater reporting credibility for their stakeholders.*[1]

The progress in the area of sustainability reporting is evident through the creation of the Global Reporting Initiative[2] (GRI) and the GRI's plans to prepare a sectorial supplement on sustainability reporting for the public sector. In the public sector, considerable efforts have been made to address the environmental area, particularly by national and international accounting bodies. For many, this has been the major area of interest, promoted in no small way by non-government organisations such as Greenpeace.

While there is no agreed definition of precisely what sustainability reporting comprises and covers, it is currently fairly widely accepted that, at its narrowest, the term 'sustainability' is used to describe the framework for measuring and reporting organisational performance against economic, social and environmental indicators. At its broadest, the term is used to capture the full set of values, issues and processes that organisations must address in order to create economic, social and environmental value and to minimise any harm resulting from their activities[3]. 'Sustainability reporting' is now generally interchangeable with the notion of 'triple bottom line reporting'.

Sustainability Reporting is generally accepted as a strategy to achieve sustainable development. The World Commission on Environment and Development introduced the concept of 'sustainability development' in 1987, defining it as "development that meets the needs of the present, without compromising the ability of future generations to meet their own needs"[4].

The emphasis today is on sustainability reporting, reflecting accountability and transparency, which is also important for good corporate governance and the concept of 'corporate social responsibility'. As such, there is an apparent shift in focus on performance from largely a short-term view to a more medium to longer-term outlook. As with its reputation, any organisation, for example, has to look outside itself to determine how well it is doing. Fortunately, we do have both national and international benchmarking partners. As well, we have a common interest in economic, social and environmental issues which are more often covered in performance or value-for-money audits.

2. Sustainability Reporting in Government

Sustainability reporting has grown in popularity in the private sector by virtue of investment ' … in the shares of companies that are believed to be doing the right thing on a range of ethical, social and environmental issues'[5]. This notion is supported by a recent report by the Association of British Insurers, which concludes:

> *The growing body of evidence of the financial impacts of socially responsible investing and responsible corporate activity suggests several important conclusions:*
>
> - *the weight of evidence does not support traditional assumptions about the negative impact on risk or returns of introducing social, environmental and ethical investment criteria. On the contrary, incorporating social, ethical and environmental criteria can reduce volatility and increase returns;*
> - *social and environmental impacts do not fall uniformly across or within sectors – some companies are more or less exposed than others, just as with conventional business drivers;*
> - *companies are not equally skilled at managing the impacts, even if they are equally exposed; and*
> - *investors and lenders, therefore, need detailed information on specific company exposures, but also strategies and success in managing those exposures.*
>
> *The social, technological and economics forces, which have pushed corporate responsibility up the political and business agendas, show no sign of slackening. As social, ethical and environmental issues become more important, investors will need to take more account of them, and investment managers or advisors who fail to do so will be in danger of failing their clients.*[6]

The initiative to undertake sustainability reporting within the Australian Government Public Sector (AGPS) is timely and consistent with the contemporary expectations of transparency and accountability for both financial and non-financial organisational performance. In the AGPS, Chief Executives of agencies are required to promote proper use of resources[7]. The production and verification of sustainability reports is consistent with fulfilling this responsibility and may contribute to greater transparency and accountability.

In general, apart from the possible changes in internal organisation and management that sustainability approaches and reporting might encourage, perhaps the most significant change is the way government might communicate with the community and stakeholders in the provision of its services and operations. In principle, such information should serve multiple purposes – reflecting objectives; setting targets;

assisting in the evaluation of alternatives to achieve the goals most efficiently and effectively; allocating resources to competing needs; evaluating performance in service delivery and accountability for public money – in summary, as an integrated performance management framework.[8] Sustainability reporting can be seen to be integral to such a framework.

The combination of producing the sustainability report and going through the verification process can result in changes to work practices. The increased focus on social and environmental factors flow down to most levels of decision-making within the organisation. In addition, a number of areas have been identified where future cost savings and efficiencies could be gained through management action towards achieving measurable increased social, environmental and economic performance.

The Australian National Audit Office (ANAO) has participated in conferences of the International Organization of Supreme Audit Institutions (INTOSAI) Working Group on Environmental Auditing (WGEA) and has been invited to become a Member of that Group. The Canadian SAI has taken a lead role in the Group and would be better qualified to speak on its activities. Our interest to date in the Group's work has been mainly in the performance audit area where we have exchanged information on methodologies, test programs, audit criteria, and reports. We have also shared information on what national governments are doing on sustainable development and reporting.[9]

I note that a Group paper (authored by SAI United Kingdom) commenting on standards for sustainable development indicated that they may originate:

> *in international accords or legislation, national legislation, programme promises and commitments, operational standards adopted by the audited body or generally accepted procedures and practices in organisations with similar activities.*[10]

The Group has also produced '*Guidance on Conducting Audits of Activities with an Environmental Perspective*'.[11] According to the Group, environmental auditing can encompass all types of audit: regulatory (financial and compliance) and performance audits. During an audit of financial statements, environmental issues may include the following:

- initiatives to prevent, abate, or remedy damage to the environment;
- the conservation of renewable and non-renewable resources;
- the consequences of violating environmental laws and regulations; and
- the consequences of vicarious liability imposed by the state.[12]

The paper, '*Environmental Auditing and Regulatory Auditing*', authored by SAI New Zealand, demonstrates, inter alia, that SAIs do not need to have a performance audit mandate to conduct audit work that has an environmental focus.[13]

In 2002-2003, the Australian Department of Family and Community Services (FaCS) produced its first Triple Bottom Line (TBL) Report. They are commended for taking the initiative to produce this report; the first-ever verified TBL report for an Australian Government agency. From the outset of the report's production process, FaCS staff and management requested the ANAO to perform an independent verification of its TBL Report. Auditing of the report showed a strong agency willingness to exhibit transparency and to assure the report was prepared using sound investigation and analysis of the three perspectives, even if their performance was somewhat patchy and uneven in one or more of the areas.

The Australian Department of the Environment and Heritage (DoEH) also prepared a TBL report in 2004 that was verified by my office. I applaud both FaCS and DoEH for taking this initiative that, I hope, will encourage others to do likewise, where it is cost effective to do so.

Public Sector Information

The type of information that a public sector sustainability report provides to users is an issue of some importance. In the Australian public sector there are two 'streams' of activities and information: departmental and administered. It is therefore important to understand the reporting framework that is being used.

Australian Accounting Standard AAS 29 *Financial Reporting by Government Departments* defines departmental items as those that are controlled by the agency. These essentially relate to the resources required for that agency to operate. Common examples of departmental items include salaries, payments to suppliers and property, plant and equipment. These are distinguished from tax revenues, user charges, fines and fees, and transfer of funds to eligible beneficiaries (e.g. social security payments), which are carried out by the agency on behalf of the government. This latter group is termed 'administered' items.

Schedule 1 of the current Finance Minister's Orders defines 'departmental items' and 'administered items' in terms of the outputs and outcomes framework as follows:

- *'Departmental items' cover those assets, liabilities, revenues and expenses over which the entity has control that are applied to the production of the entity's own outputs.*
- *'Administered items' are assets, liabilities, revenues and expenses that the entity does not control and which are subject to highly prescribed rules or conditions established by legislation, or Australian Government Policy in order to achieve Australian Government outcomes.*[14]

It should be noted that the sustainability reports only cover the agency's departmental activities. For these areas, it is appropriate for my office to verify the information presented. The main issues for us are appropriate standards and skills.

Sustainability reporting on administered activities would draw the ANAO into analysing the appropriateness of the Government/Ministerial decision-making. This is outside the scope of the audit mandate. While it may not be appropriate for the ANAO to analyse Government/Ministerial decision-making, agencies that are charged with delivering administered activities are still responsible for the efficient implementation of those programs. This is evidenced by inclusion of key performance measures in relation to these activities in agencies' Budget documents and annual reports. As a consequence, these activities would fall within the scope for ANAO comment. Interested stakeholders would no doubt expect to see some kind of sustainability indicators for such expenditure by the relevant agencies in any sustainability reporting. To that extent, the issues may go wider than this Australian experience might suggest.

3. Sustainability Reporting & Verification from an Auditor's Perspective

The ANAO initially had a number of reservations around providing a verification statement over FaCS' first attempt to produce a sustainability report, as we were concerned that a large amount of information might not be verifiable. As such, any modified audit report could detract from the importance of initiatives taken in the public sector in this respect and might be counter-productive to further progress at that time. However, FaCS' commitment to being open and transparent and their enthusiasm for the verification encouraged the ANAO to undertake this assignment.

Verification of sustainability reports is optional for both private and Australian Government organisations. The credibility of the sustainability report will depend on the criteria used to produce it, its transparency and, increasingly, on whether it has been independently verified[15].

Verifying sustainability information is not an easy task. Some of the areas of difficulties for auditors when verifying sustainability information include:

- lack of mandated standards for a systematic process as well as the paucity of evaluation criteria for verification of this information;
- lack of available information to assess performance;
- lack of clarity of information presented;
- developing a sound basis for materiality decisions;
- resolving audit issues relating to publication of the sustainability report itself; and
- developing and/or acquiring specialist skills required to verify sustainability information.

I will now elaborate upon each of these issues in turn.

Lack of mandated standards

An increasing number of companies worldwide have been producing sustainability reports. To further enhance their credibility, early adopters have progressed to independent verification of those reports. Although accepted global standards are not yet available, companies are developing and reporting against their own standards or measures to reap the rewards of demonstrating goodwill with such reporting[16].

The trend in producing guidance to audit non-financial information began to take shape in 1993 when the European Council of European Union adopted the Eco-Management and Auditing Scheme (EMAS). In addition, EMAS requires companies to prepare publicly available environmental reports that must be validated by a qualified third party, that is, an accredited EMAS verifier.

The International Organization for Standardization (ISO), the Coalition for Environmentally Responsible Economies (CERES), and the Council on Economic Priorities (CEP) have established principles, guidelines and standards for various approaches to reporting and auditing on environmental and (in the case of CEP) social performance.

One of the more influential sets of voluntary environmental standards is the ISO 14001 Environmental Management Standard, introduced in 1996, which enables a company to design, implement, and monitor an environmental management system. ISO 14001 provides objective criteria against which to audit company environmental management systems. While many companies are adopting ISO 14001, the standard only recommends that organisations should report their performance to stakeholders; it does not specify the content nor format of those reports. Furthermore, ISO 14001 does not address social performance[17].

The current accounting and auditing standards frameworks do not include specific guidance on preparing, or verification of, sustainability reports. In June last, the Australian Auditing and Assurance Standards Board issued Australian Auditing Standard AUS 110 *Assurance Engagements other than Audits or Reviews of Historical Financial Information.* This standard establishes basic principles and standards to be applied by auditors when completing work such as verification of sustainability reports.

When verifying TBL reports, the ANAO uses the Global Reporting Initiative (GRI) Guidelines as the main source of auditing criteria. This was supplemented by the Standards Australia draft standard *General Guidelines on the Verification, Validation and Assurance of Environmental and Sustainability Reports (DR 03422).*

The GRI Guidelines include key performance indicators for environmental, economic and social performance, and a framework within which to set the key performance indicators. The GRI issued revised guidelines in June 2002 and intends updating them again in 2005. A supplement to these guidelines specifically for the public sector has recently been drafted. According to surveys, the reporting criteria most frequently mentioned in assurance reports are the GRI guidelines. However, more than half of such reports cite no reporting criteria.

A recent study in the United Kingdom indicated that there is a clear need for integrating corporate social responsibility into the ISO management systems[18]. Such an approach would lead to a more standardised global approach to this type of reporting covering key elements such as:

- compliance with all rules and regulations of the jurisdiction in question and relevant international norms pertaining to the environmental, consumer, fair labour standards, human rights, and health and safety protection, as agreed upon through a meaningful stakeholder engagement process;

- processes for meaningful stakeholder engagement;

- development, implementation and communication of corporate responsibility and corporate ethics policies, including those pertaining to anti-bribery and corruption;

- training for socially responsible governance;

- relations with communities, philanthropy, outreach and involvement; and

- measurement and regular reporting to the full range of stakeholders and the general public.[19]

A decision to develop a Standard for Social Responsibility at an ISO Technical Management Board meeting was taken in Stockholm last June[20]. The ISO's Advisory Group on Social Responsibility recommended that there was a need for a guidance document, and not for a specification document intended for conformity assessment.[21] This seemed to be taking a pragmatic position as there had been some earlier support for third-party certification.

Limited evidence to test non-financial information

The information reported in a sustainability report is generally non-financial in nature, and may relate to aspects of the organisation that are not accustomed to the rigors of being audited. The organisational areas affected may not be as familiar with requirements being placed upon them to maintain appropriate books and records, as required for financial information, and adequate documentation to support the information presented. An example of this situation relates to where data is being sought about an aspect of the organisation that is not routinely or systematically collected, or is not strictly required (that is, it is provided only on a voluntary basis). These deficiencies are often a reflection of a wider problem of the lack of adequate record-keeping.

In such instances, it may be difficult for the auditor to gain assurance as to the completeness, accuracy and reliability of the information being presented. However, the International Auditing and Assurance Standards Board (IAASB) has set up a Panel of Experts, chaired by Professor Roger Simnett who is a Member of the IAASB, both to liaise with the GRI in order to influence the form and content of the next version of the GRI Sustainability Reporting Guidelines so that they will be generally accepted as suitable criteria for assurance engagements, and to develop guidance for assurance practitioners on sustainability engagements.

The Expert Panel, referred to above, has three broad areas of work that are of considerable interest to auditors, as well as to preparers:

1. measurement issues;

2. reporting issues, with the GRI being one model; and

3. providing assurance.

The IAASB will provide guidance, as well as the International Federation of Accountants' Professional Accountants in Business (PAIB) Committee. The latter Committee has recently expressed some concern at the current quality of assurance services, as being reported, which needs to be addressed. Despite the difficulties of identifying suitable criteria that are generally applicable and accepted across countries and, indeed, across industries, there appears to be growing international commitment to using accepted standards. This makes the work of the IAASB Panel even more important and worthy of more general support, including from the public sector.

Clarity of information presented

As the sustainability report is largely based on non-financial information, the latter needs to be presented carefully, in either a narrative or tabular format, so that it is clearly understandable and avoids misleading users of the report. As such, the 'expression' used becomes a very important aspect of sustainability reporting. Care is taken, from an auditor's perspective, to ensure that there is clarity of information provided with the narrative and that tables present such information both accurately and in an honest and ethical manner.

Consideration of materiality

The verification statement provided after the completion of the ANAO's work to verify the sustainability information presented by AGPS agencies provides users with assurance that selected data was, <u>in all material respects</u>, found to be complete, accurate and reliable.

The concept of 'materiality' is clearly important in the auditing profession as it defines the level of assurance provided by the work completed by an auditor. Put simply, the level of assurance provided is not about being 100 per cent accurate, rather it is assurance that the information is 'materially' correct within the parameters set, either by the nature or dollar value of that information.

The term 'materiality' is defined in both accounting and auditing standards as follows:

> *'Materiality means, in relation to information, that information which if omitted, misstated or not disclosed has the potential to adversely affect decisions about the allocation of scarce resources made by users of the financial report or the discharge of accountability by the management or governing body of the entity.'* [22]

From an auditing perspective, materiality is considered when assessing areas of risk and the impact of errors and/or irregularities recorded, during the audit process. As already noted, materiality is assessed both in terms of nature and quantum. The concept continues to be difficult to explain to Parliamentary Members in particular and the general public at large.

A difficulty noted for auditors verifying sustainability information is how to practically apply the concept of materiality to non-financial information. To this end, the ANAO ensures the level of materiality being applied throughout the verification process is clearly communicated to the client, and clearly explained in the verification statement for the benefit of users.

Audit issues in relation to publication of sustainability report

There are a number of issues of interest related to the publication of a sustainability report.

Currently, the Australian Department of the Prime Minister and Cabinet issues guidelines about presentation and disclosure of AGPS agencies' performance. These guidelines 'drive' the content of AGPS agencies' annual reports. Should sustainability information be included as part of these guidelines, regardless of whether the agency sought to have the sustainability information verified, some additional procedures would still need to be undertaken by the ANAO as part of its financial statement audits and reviews of performance management.

The latter imperative applies by virtue of the requirements in the Australian Auditing Standard AUS 218 *Other Information in Documents Containing Audited Financial Reports*. This standard requires auditors to check for material inconsistencies between:

- the information contained in the audited financial report; and
- the information contained in other parts of the same document.

Material inconsistencies between these two elements may raise doubt about the audit conclusions drawn from audit evidence previously obtained and, possibly, about the basis for the auditor's factual findings.

The level of assurance provided by sustainability reports is uncertain, both from an auditor's perspective and mostly importantly from the users' perspective. A study by IFAC in 2002 found that a significant portion of the 'moderate' assurance reports being issued in practice related to environmental and sustainability reports[23].

Users could be confused if they are provided with an audited financial report providing a high level of assurance, and a sustainability report that provides only a moderate level of assurance. This distinction is clear to the auditor, but users may not notice, or appreciate, the difference that could lead to a new or exacerbated audit expectation gap.

Also at that time, a survey of shareholders was conducted to investigate this issue and discovered the opposite effect on users' understanding of different levels of assurance. The study found that, after considering audit reports providing various levels of assurance, users perceived a significantly lower level of assurance for the audit reports providing only moderate assurance, compared to that for high level assurance reports[24].

Specialist skills required to verify sustainability information

By its very nature, information presented in sustainability reports is not all of a financial nature, as already noted. Experience shows there are some specific skills that are required to verify this information, which may differ from those required to complete an audit of a set of financial statements or even most performance audits.

A survey of shareholders in November 2002 was conducted as part of assessing the information needs of users. The survey found that almost all respondents believed that evidence collection and evaluation should be done with the assistance of other experts, such as environmental engineers[25].

While the ANAO has identified some synergies between the 2003-2004 financial statement audit of the FaCS and the verification of their 2003-2004 sustainability report, we also required assistance from an external accounting firm with acknowledged relevant skills and experience to complete work required on the sustainability verification. Over time, the skill sets that these external staff currently provide will need to be developed within the ANAO, particularly if there is an increase in preparation of sustainability reports by the Australian Government agencies. To date, there has been some skills transfer from the private sector. As well, we have learnt from our contacts with other audit offices and from the agencies themselves.

4. Developments in Sustainability Reporting

It is instructive to consider a number of developments, both in Australia and overseas, in relation to sustainability reporting, which might provide us with greater confidence to consider taking such an initiative in our own organisations.

Recently, CPA Australia's Audit and Assurance Centre of Excellence published a database on their web site of over 160 companies worldwide that publish sustainability reports accompanying their financial reports. This database provides information about these reports, including a listing of those providing sustainability audit services. The database is designed to support research undertaken by RMIT[26] University's school of Accounting and Law that " … aims to provide a better understanding of how sustainability principles are being applied within organisations in Australia and around the world"[27].

This commitment to sustainability by CPA Australia shows the increasing importance of this type of reporting as a way of Chief Executives discharging their accountability as well as promoting the reputation and image of their organisation.

The ACT Government is also looking to implement sustainability reporting in its agencies. However, that initiative involves looking to implement sustainability budgeting rather than 'ex-post' sustainability reporting. The provision of budget information in relation to sustainability is expected to stress the importance and interdependence of economic, social and environment well-being, and provide a better context for informed decision-making about the allocation of resources[28].

The importance of considering the broader impacts of decisions made is becoming more prevalent at a time when shareholders are looking to, and questioning, sustainability reports to gain an understanding of the company's broader social impact.

While shareholders were previously only presumed to be interested in receiving a return on their investment, they are now increasingly assessing if they are investing in 'clear conscience'[29], and even demanding change where they feel a company is not adequately performing in a financial, social and environmental sense.

There have also been significant developments in the United Kingdom (UK) in relation to both Corporate Social Responsibility (CSR) reporting and its subset, Operating and Financial Review (OFR) reporting.

As with sustainability reports, CSR reporting is a broader approach to corporate reporting, taking into consideration the entity's broader impact upon its local community, and the global community at large. Gordon Brown, the Chancellor of the Exchequer, recently described the importance of CSR as follows:

> *Today, our corporate social responsibility goes far beyond the old philanthropy of the past – donating money to good causes at the end of the financial year – and is instead an all year round responsibility that companies accept for the environment around them, for the best working practices, for their engagement in their local communities and for their recognition that brand names depend not only on quality, price and uniqueness but on how, cumulatively, they interact with company's workforce, community and environment. Now we need to move towards a challenging measure of corporate responsibility, where we judge results not just by the input but also by its outcomes: the difference we make to the world in which we live, and the contribution we make to poverty reduction.*[30]

This initiative has arisen from the Company Law Review, which was later endorsed by the British Government in its "Modernising Company Law" White Paper in July 2002. This paper included the following three broad proposals to improve corporate governance:

- *a statement of directors' duties;*
- *improved transparency and accountability, with improvements to the quality, timeliness and accessibility of information available for shareholders and others; and*
- *more effective machinery for enabling and encouraging shareholders to exercise effective and responsible control.*[31]

A related area of interest is Environmental Management Accounting (EMA).[32] While there is considerable literature in this area, particular interest has been shown by the accounting profession in work being undertaken by a United Nations Expert Working Group on EMA. IFAC staff have been engaged with the Group in codifying thinking developed by a range of authoritative bodies into a single international guideline. Work is proceeding on a guidance document expected to be available in the near future with comments due shortly after this Conference is held (that is, February 2005).

For the purpose of the guidance document, the EMA definition used by the UN Group has been adopted as it more distinctively highlights both the physical and monetary sides of EMA as follows:

- EMA is broadly defined to be the identification, collection, analysis, and use of two types of information for internal decision-making:
  - physical information on the use, flows, and fates of energy, water and materials (including wastes); and
  - monetary information on environment-related costs, earnings and savings.

EMA places a particular emphasis on materials-related costs because materials purchase costs are a major cost driver in many organisations and use of energy, water and materials, as well as the generation of waste and emissions, are directly related to many of the impacts organisations have on their environments. Core reasons for the current level of international interest in EMA include:

- increasing pressure from stakeholders interested in environmental issues;
- increasing importance of environment-related costs; and
- increasing recognition of problematic accounting practices.

As mentioned earlier, external auditors play a key role in verifying the accuracy of the information reported, as well as verifying the information systems and practices from which the reported information is derived.

5. Concluding Comments

In conclusion, I would like to reiterate that, via conferences and seminars, such as this one today, there is a growing momentum in both the importance and perceived benefits of sustainability reporting. A range of international reports and surveys indicates the growing demand for assurance and predictions that the trend will increase over time.

It has been of considerable advantage to the ANAO to take part in the initial application in the Australian Government of this type of reporting, and encouraging enhancement of public sector reporting and governance in this respect. It is still early days for us but we are learning quickly. There was some improvement in reporting by the Family and Community Services Department this year but there is still some way to go in terms of coverage and performance. The report by the Department of the Environment and Heritage was more limited than expected and under-provided in terms of audit coverage.

While there are some broad-based and more specific public sector issues relating to both the preparation and verification of these reports, the intention to provide users with additional information, providing further transparency and demanding broader accountabilities, is to be commended and supported. However, it is also important that we promote the need for guidance into the standards process that provides a credible basis for both reporting and auditing. By doing so, we engender confidence in all stakeholders and, consequently, greater acceptance and demand for application of the triple bottom line concept and related notions of sustainability and corporate responsibility.

For the future, at least two reports by the INTOSAI Working Group on Environmental Auditing will be of considerable interest – one being '*Summary of Environmental and Sustainable Development Audits*' under the leadership of SAI Canada, and the other capturing lessons learned and sharing experiences in conducting audits on sustainable development under the leadership of SAI United Kingdom.

Notes and References

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[32] Environmental Management Accounting has no single, universally accepted definition. According to IFAC's Statement, *Management Accounting Principles*, published in 1998 (para 1), EMA is "the management of environmental and economic performance through the development and implementation of appropriate environment-related accounting systems and practices. While this may include reporting and auditing in some companies, environmental management accounting typically involves life-cycle costing, full-cost accounting, benefits assessment, and strategic planning for environmental management".