Environmental Audit as a Regulatory Strategy: Prospects and Reform

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1. *Introduction*

Escalating social and political concern about the environment has forced policy-makers to consider new and innovative methods of curbing pollution. One "new generation" mechanism which promises to make an important contribution to environmental protection is the environmental audit. Audits can provide systematic, documented, periodic and objective reviews of whether environmental requirements are being met,[1] and are used for a wide variety of purposes. These include evaluating compliance, land contamination, equipment performance, risks and hazards, impact predications, planning systems, monitoring design and management programs.

Audits are becoming a substantial focus of effort world-wide,[2] largely because they promise to provide management with substantially improved environmental performance. Specifically, audits are claimed to reduce exposure to litigation and criminal penalties, to improve risk management, operating performance and planning, to reduce costs through recycling, waste minimisation and material substitutions (which might otherwise not be identified as viable) and to achieve environmental goals more efficiently and with less application of government resources.[3]

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1 See United States Environment Protection Agency (hereafter, USEPA), *Environmental Auditing Policy Statement* 51 Fed Reg 25004, 9 July 1986.

2 In the USA audits are already performed regularly by over two-thirds of the larger companies in the basic manufacturing and process industries (Hogan, E A and Bromberg, L M, "The Hidden Hazards of the Environmental Audit", (1990) 36 *Practical Lawyer* 15). They are also performed by almost 40 per cent of the top 1,000 Australian organisations with a substantial increase in that percentage anticipated in the near future (Hibbert, S, "Environmental Auditing: Assembling the Team — the Lawyer's Role" paper presented to *Second National Environmental Law Association (NELA)/LawAsia International Conference on Environmental Law* (1991)).

3 See generally, Court, J, "Environmental Auditing: Some Developments in the New South Wales Approach", *Proceedings of Australia and New Zealand Environment and Conservation Council (ANZECC) Workshop on Environmental Auditing of Industrial Facilities*, Melbourne, EPA, (1991) at 8. For South Australia, see "Establishing the South Australian Environmental Protection Authority" Department of Environment and Planning (1992).

Clearly, environmental audit is going to make a considerable contribution to environmental protection in Australia in the 1990s. Victoria has already enacted legislation specifically addressing issues of environmental audit, New South Wales and South Australia are likely to do so shortly, and other jurisdictions are also exploring the possible role of environmental audit within their proposed new schemes of environmental regulation.

Although there has been much recent writing on the subject of environmental audit, the majority either extols[4] (or challenges[5]) the virtues of engaging lawyers to perform such audits, describes the practical mechanisms involved in such audits,[6] or explores the problems of maintaining the confidentiality of the audit report.[7] In sum, most of that literature is heavily client-oriented. What is largely lacking is any serious evaluation of the social policy implications of environmental audit, of the extent to which it might appropriately be used as a regulatory tool, or any concern to specify precisely how and under what circumstances audit is most likely to make a substantial contribution to environmental protection.

This article seeks to fill that gap in the existing literature. It is in five parts. The first describes the various types of environmental audit and the functions they serve. The second explores the current and contemplated legislative provisions in Australia with respect to environmental audit, focusing primarily on Victoria and New South Wales, where those provisions are most well developed. The third section argues that environmental audit could be much more than just a management tool and that new types of audit could make a major contribution to overall regulatory strategy. Drawing on overseas experience, and extrapolating from other areas of social policy, this section explores the circumstances in which new forms of audit might appropriately be invoked. The fourth section draws on the insights of recent work in the area of regulatory policy and shows how that broader theorising is in harmony with the more specific and grounded arguments expressed in this article. The final section

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4 Cogen, R, Ford, M E and McCreary, J H, "What you Need to Know About Environmental Audits" (1989) 35 *Practical Lawyer* 17; Ibbotson, P, "Environmental Compliance Programmes and Dealing with the Practical and Legal Issues of Environmental Audits" *3rd Annual Pollution Law Conference*, 28-29 October 1991; Hibbert, above n2.

5 Juleff, M and Jaycock, N, (Richard Oliver Risk Managers Pty Ltd) "Environmental Audit: Issues for Management" in Business Law Education Centre Managing Environmental Risks and Environmental Audits (1990) 135-51; Ayling, G M, "Environmental Auditing: A Need to Lift the Performance of Professionals" in Business Law Education Centre (BLEC) (1990).

6 Schnapf, L, "Components of Environmental Due Diligence Investigations", (1990) 5 *J Int'l Bank FL*, 12; Myer, K and McCaffery, T, "The Goals and Techniques of Environmental Audits" (1984) 30 *Practical Lawyer* 41. For the Australian context: Brown, G, (1990), "Reaping the Benefits of Environmental Auditing", paper presented at the *Strategic Environmental Management Conference*, 27-28 June 1990. See also papers presented at *Environmental Auditing Conference*, 7-8 November 1990; and papers presented at *Pollution Law Conference*, 17-18 September 1990. For a company level view Veldhuizen, H, "Noranda Inc's Environmental Auditing Program", in United Nations Environment Programme, in *United Nations Environment Programme (UNEP), Environmental Auditing — Report of a Industry and Environment Workshop* (1989).

7 Mann, G, "Internal Environmental Audits: Can Legal Professional Privilege Be Claimed?" (1991) 8 *EPLJ* 179. For Canadian perspective: Edwards, P, "Confidentiality in Environmental Auditing" (1990), *J Environmental L Practice*; Hogan and Bromberg, above n2.

summarises the potential benefits of environmental audit as a regulatory mechanism, arguing that despite some inherent limitations, audit can and should play an important role in an overall environment protection strategy.

2. *Environmental Audit: Definition And Distinctions*

There is no uniformly accepted definition of environmental audit and there is no such thing as a "typical" audit.[8] This is largely because many different groups use audits for many different purposes, and because they interpret the term according to their own objectives.[9] For present purposes, we refer to the Victorian statutory definition, whereby an audit is defined as:

> a total assessment of the nature and extent of any harm or detriment caused to, or the risk of any possible harm or detriment which may be caused to, any beneficial use made of any segment of the environment by any process or activity, waste, substance (including any chemical substance) or noise.[10]

The most common form of environmental audit is a survey of the activities of a corporation or other entity by a consultant to assess the extent of the corporation's current and potential impact on the environment. This can involve any number of different types of investigation. It may begin with a visit to the corporation's site or plant, progress to a "desk top survey" of its activities and past environmental record and policies, and move on to scientific analysis of its processes, products and waste stream. In the vast majority of cases, the audit will be voluntary, in which case it will involve either an in-house auditing team,[11] or an independent third party contractor. No other party will be involved unless, exceptionally, government requires access to the audit results. However, where the audit is compulsory, then it necessarily involves a further party, namely the government agency which will either conduct or require verification of the audit results.[12]

There has been much unnecessary confusion as to the function and types of expertise necessary to conduct an environmental audit. As Fowler points out, much of the disagreement could be avoided by carefully distinguishing between the three main types of audit: operational; transactional; and environmental impact assessment auditing and by classifying the most common forms of audit in terms of these main types.[13]

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8 Buckley, R, "Environmental Audit: Review and Guidelines" (1990) 7 *EPLJ* 127.

9 For widely used definitions, see International Chamber of Commerce, "Position on Environmental Auditing" (1989) 19 *Environmental Policy Law*, 82-4; USEPA above n1; and World Wide Fund for Nature cited in Hardwick, "Learning to Live with Green Law", (1991) in Carr, J (ed), *Environmental Risk: A Legal Guide to Prevention and Cure Worldwide*, supplement to (1991) 1 *Int'l Finance LR* at 3-6.

10 *Environment Protection Act* 1970 (Vic) s4. For the definition proposed for the NSW EPA see Court, above n3 at 11. Note the NSW definition is more closely modelled on definitions in corporate environmental management literature.

11 For general descriptions of the internal auditing practices of multinational corporations see UNEP above n6. For a description of ICI Australia's internal audit teams, Hooper, N, "Audits Make it Easier to be Green" *Business Review Weekly*, 11 May 1990 at 47-49. For discussion of practices of other Australian companies: Brown, above n6 at 2.

12 As indicated below, at present Victoria is the only jurisdiction with any provision for compulsory audit.

13 Fowler, R J, "Environmental Auditing: A New Field for Professionals" presented to Australian Evaluation Society's National Conference, 3 October 1991.

A. Operational Audits

(i) Compliance Audits

A compliance audit is an independent assessment of a particular operation, be it a factory, building, corporation, government department or industrial site. The aim is to discover if the operation is complying with existing (or predicted) statutory requirements and in consequence the audit is narrowly focused on potential legal liabilities.

In the case of a voluntary compliance audit, the primary aim is to ensure regulatory compliance and to reduce exposure to liability. When the audit is mandatory, the purpose is to provide relevant information regarding compliance to the regulator, as well as to the regulated body. This might then form the basis for subsequent agency action.

(ii) Environmental Management Audits

In contrast, an environmental management audit is a much wider survey of the environmental impact and implications of all of a corporation's products, marketing strategy, inputs, processes, management systems and outputs.[14] Such an audit is usually initiated voluntarily by an enterprise in order to improve corporate management practices, with a view to generating efficiencies and achieving substantial cost-savings.[15] These comprehensive audits have the added advantage that, in extending beyond activities which are currently regulated they may not only improve corporate management practices, but also provide a means of avoiding future regulation or liability.[16] Such wide-ranging operational audits have sometimes been referred to as "environmental surveys".[17]

B. Transactional Environmental Audits

Transactional environmental audits are undertaken principally to ascertain whether or not any property is contaminated or likely to be contaminated. Such audits will be most common in the following contexts:

(i) The sale of land or a business

Increasingly, transactional environmental audits are undertaken prior to transfer of ownership of a corporation or real estate. They are an attempt on the part of the purchaser to assess the true value of the property and to avoid incurring liabilities for past environmental damage. Liability for such damage, in the absence of an effective audit, might unwittingly be transferred with ownership, because of environmental legislation in Victoria, New South Wales, Queensland[18] (and contemplated in South Australia)[19] which contains wide-

14 Ayling, above n5; Brown, above n6.

15 Brown, above n6.

16 Ayling, above n5.

17 For example, Walker, M, "The Environmental Survey: Strategic Planning for the Environment" (1988) 3 *National Resources and Environment* 29.

18 *Environmentally Hazardous Chemicals Act 1985 (NSW) s35, Environmental Offences and Penalties Act 1989 (NSW) ss5, 6, 14; Environment Protection Act 1970 (Vic) ss62, 62C; Contaminated Land Act* 1991 (Qld) ss3, 20. For comment: Dougall, N, *Land Contamination: Who is Liable for the Costs of Cleaning Up?* (1991) Clayton Utz unpublished.

19 Cole and Assocs, *Contaminated Land: A South Australian Legislative Approach*, (1991),

ranging (strict and retroactive) definitions of liability in relation to the clean up of contaminated sites. As a result, mere occupation of land may be sufficient to attract environmental liability. Accordingly, transactional audits are increasingly being utilised to determine the current and potential legal and financial liabilities associated with a site, project, operation, corporation, or subsidiary.[20] Environmental audits may also be undertaken prior to any proposed takeover or merger. This is because the potential cost of corporate clean ups and site remediation often associated with them is sufficient to affect the overall viability of a planned acquisition.[21]

(ii) Lending and insurance audits

Australian banks and lending institutions have taken a keen interest in environmental auditing since the enactment of contaminated sites legislation.[22] Australian lending institutions are following the lead of US banks since the enactment of the *Comprehensive Environmental Response, Compensation and Liability Act* 1980 and its interpretation in *United States v Fleet Factors Corp*[23] The Act empowers the United States Environmental Protection Agency (USEPA) to recover costs for the clean up of contaminated sites from a number of parties beyond the current owners.[24] In *Fleet* it was held that a bank can be held liable for cleaning up a site if it has "operated" a site through involvement in the management of a borrower, regardless of whether or not the bank chose to exercise that capacity to influence the borrowers' environmental decisions. As Australian jurisdictions increasingly adopt the American model in enacting contaminated land legislation, so banks in Australia are also taking into account the effects on their potential liabilities under that legisla-

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Green Paper for Waste Management Commission and Dept. Environment & Planning. At the Federal level, the *Draft Guidelines for the Assessment and Management of Contaminated Sites*, (1991) ANZECC National Health & Medical Research Council (NHMRC) called for nationwide standards for clean up of contaminated sites, and supported the concept of "strict" liability.

20 Buckley, above n8 at 132; Mfodwo, K, "Lender Liability for Environmental Problems" (1992) 9 *EPLJ* 61. See also Carney, P, "Environmental Auditing: Objectives, Elements & Means", (1991), *Second NELA-LawAsia Conference on Environmental Law* at 6 who notes that a vendor may also wish to ensure that it is aware of any liabilities it may incur under the contract, and have appropriate terms inserted in the contract.

21 It is standard practice in the US and many EC countries that a certificate of environmental audit is required by acquisitors prior to finalising a sale. Mergers & Acquisitions (M&A) environmental audits are an integral and commonplace aspect of US M&A audits. Carney, above n20 at 5.

22 On Australian lending: Davey, C, Henschke, M, (National Australian Bank), "Allocating Environmental Risks Between Borrowers and Lenders", (1990) Paper presented to *IIR Conference on Pollution Control, Sydney. See American Banker, passim; Gentry, B, Cameron, J, "Environmental Costs: Making Lenders Liable", (1991) 10 Int'l Finance LR 25.*

23 901 F2d 1550 (*11th Cir* 1990).

24 Specifically, to banks, insurance companies, landlords on behalf of their tenants, and successor corporations. Thus bankers, for example, could find themselves liable for the remediation of land contaminated by clients, when they foreclose on properties. See Anhang, G, "Cleaning Up the Lender Management Participation Standard Under *Comprehensive Environmental Response Compensation and Liability Act* 1980 in the Aftermath of *Fleet Factors*": (1990) 15 *Harv Environmental LR* 235. For background see: (1986-87) 7 *Stanford Environmental LR*. For UK Perspective: Note, "Digging Deep: Re-using Contaminated Land" (1991) 87 *Conveyancer & Prop. Lawyer* 249.

tion. In circumstances of default or potential foreclosure audit procedures will be particularly important, given the necessity for lenders to assess the value of their collateral as well as any potential liability arising if they take possession of contaminated property.[25]

As a result of this legislation, insurance companies may also require a certificate of audit before offering environmental liability insurance to corporations.[26] So far, the Australian insurance industry has been slow to respond to the new situation, and most Public Liability and Industrial Special Risk policies currently provide only very limited cover or even exclude entirely, environmental liability claims. However, as Fowler points out, "once such special liability cover becomes available in Australia, environmental audits are likely to become a routine prerequisite to the obtaining of such insurance".[27]

C. *Environmental Impact Assessment Audits*

The third broad category of environmental auditing is the auditing of environmental impact assessments (of particular projects) after the event in order to determine the accuracy of their predictions.[28]

As Fowler notes, such audits are likely to be either:

(i) imposed on developers as a result of conditions attached to licences or consents or ...

(ii) through the amendment of existing Environmental Impact Assessment (EIA) measures so as to impose requirements upon project proponents.[29]

This article focuses primarily on industrial audit (category (a) above). Industrial audits are not only becoming the most important and widely used type of environmental audit in Australia, they also raise in particularly acute form, complex and broad questions concerning the role and effectiveness of audits, their relationship to other regulatory mechanisms and their place in the overall regulatory mix. Accordingly, in the following sections, our concern is with operational audits (of which the industrial audit is the principal form) rather than with transactional or EIA audits.

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25 Credit agreements have also been rewritten to require the borrower to supply copies of pollution licences, and to make allowance for the costs of environmental audits and inspections Forman, D, "Environment Protection Cost Could Affect Commercial Credit" *BRW* 27 September 1991 at 95.

26 On insurance audits: see *Lloyds List* 29 June 1990 at 4; 11 September 1991 at 10; 29 March 1991 at 18; 6 November 1990 at 5; 26 October 1991 at 12 [via Reuters Textline]. McDonald, J, "Key issues in environmental insurance litigation" (1991) 8 *EPLJ* 145.

27 Fowler, above n13 at 7.

28 Buckley, R, "What's Wrong with EIA?" (1989) 20 *Search* 146; "Adequacy of Current Legislative and Institutional Frameworks for Environmental Impact Audit in Australia", (1990) 7 *EPLJ*, 142; Tomlinson, P and Atkinson, S F, "Environmental Audits: Proposed Terminology" (1987) *Environmental Monitoring and Assessment* 187; "Environmental Audits: A Literature Review" (1987) 8 *Environmental Monitoring Assessment* 239.

29 Fowler suggests the use of s49(8) of the *Planning Act* 1982 (SA) "which gives planning authorities in South Australia the power to impose conditions to be complied with in the future and to vary or revise conditions from time to time", above n13 at 8.

3. *The Current Legal Framework*

Victoria and New South Wales are, at the time of writing, the only Australian jurisdictions to have articulated a clear philosophy with respect to environmental audit, and to have enacted or, in the case of New South Wales, proposed legislation to implement that philosophy. It is plausible that other jurisdictions will do so in the relatively near future. Indeed, the establishment of Environment Protection Authorities or Agencies in a number of jurisdictions is likely to result in a range of new regulatory mechanisms, including environmental audit.[30] Nevertheless, the precise form of audit that other jurisdictions may adopt is as yet unclear, and for present purposes we focus primarily on Victoria and New South Wales.

A. New South Wales

Environmental regulation in New South Wales is in transition. In December 1991 the *Protection of the Environment Administration Act* was passed, replacing the State Pollution Control Commission (SPCC) with a new Environment Protection Authority (EPA) and providing an integrated administration for environmental protection.[31] However, pending its review and rationalisation, the existing regulatory framework for environmental protection continues largely unaltered by the 1991 legislation.[32]

The result is that in many respects, the new EPA currently has only the same powers as its predecessor. Like the SPCC, it has no explicit power to mandate environmental auditing, and it is unclear whether it has any implicit power to do so. The current position has been summarised by one senior New South Wales regulator as follows:

> under the Pollution Control Acts and the SPCC Act the SPCC [and now the EPA] require that information about polluting processes be provided by the licence holder or other responsible party. The degree to which this can extend to the gathering of information which does not already exist in the possession of the licensee is unclear. The SPCC [now the EPA] can also attach conditions to licences which require investigations to be undertaken and reported. However, the power has not been widely used and its validity to extend to environmental audits is untested.
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> Under the *Environmentally Hazardous Chemicals Act* the [EPA] can require by implication the investigation of contamination problems on lands and the development of plans leading to remediation of the lands.
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> The Waste Management Authority requires all licensees to submit Waste Minimisation Plans, but again the statutory basis for this is untested as the

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30 At the time of publication the Australian Capital Territory, Northern Territory, Queensland, South Australia, Tasmania were without Environmental Protection Agencies. An Environment Protection Authority has been proposed in South Australia. Department of Environment & Planning Proposal for a South Australian EPA: A Discussion Paper (1991).

31 Moore, T, "Environment Protection at the State Level — NSW EPA — A Fresh Approach", in Environmental Defender's Office-EIA (NSW) — NELA Seminar, *Environment Protection Authorities — Replacing Red Tape with Green?* (1991), at 5-8.

32 Plans originally existed for a Protection of the Environment Bill to renew and consolidate many environmental statutes in the second stage of the EPA formation process. See NSW Hansard (Assembly) 9 April 1991 at 1711.

> legislation does not explicitly specify that this action can be required as a condition of licence.[33]

This unsatisfactory and uncertain position will change when the second stage of the present restructuring takes place. This will involve a new *Protection of the Environment Act*, (probably in 1993) which will involve major substantive changes to environmental legislation, including explicit provision for environmental audit.

In respect of voluntary audits, government policy is clear. Not only will the EPA encourage voluntary management audits in a general sense, it will also (under the proposed *Protection of the Environment Act*) guarantee the confidentiality of such audits by excluding them from the class of documents available for inspection by the EPA and from the court discovery process. Thus the government seeks to avoid the situation whereby information generated by a voluntary audit (perhaps revealing past violations) is subsequently obtained by regulators and used against the audited firm in legal proceedings. Such a result would undoubtedly deter enterprises from engaging in voluntary audits, and would be counterproductive.[34] Accordingly, it is proposed that the only circumstances in which the EPA will be able to call for the production of these reports in legal proceedings is "when a company or operator chooses to use the report to support a claim of due diligence in the management of its business or to defend itself in prosecution proceedings".[35] However, measures will also be taken to ensure that, by attachment to audit documents, access is not excluded to material which would otherwise legitimately be obtained by government regulators, that is "shielding".[36]

In respect of compulsory audit, it is contemplated that:

> The EPA would ... have the power to require an audit to be undertaken or to undertake random audits for evaluating compliance with pollution control and waste management requirements.[37]

Details will remain unclear until the EPA develops guidelines and specifies requirements for the conduct of such audits. However, it is clear that such audits could be either comprehensive or for specific aspects of operations, and that they "might be used for development or furtherance of Pollution Reduction Programs which would be attached to licences or established as separate agreements with financial bonding provisions".[38] The main circumstances under which the EPA might require an audit are when regulatory provisions, licence conditions or other government or industry codes of practice have not been complied with.[39]

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33 Court, above n3 at 9.

34 Confidentiality is also important since the audit may reveal processes which are regarded as trade secrets or commercially sensitive information.

35 NSW Ministry of Environment, *Establishing the EPA for NSW* (1991) at 1.11.1.

36 See further Buckley, R, "Confidentiality of Corporate Environmental Audit Documents: Policy Issues" (1992) 9 *EPLJ*, at 297-98.

37 Above n35 at 1.11.2. EPA powers in this respect would include directing the undertaking of an audit in specific terms; approving the auditor; requiring a copy of the full audit report; and setting the terms and scope of the audit. See Court, above n3 at 12.

38 Court ibid.

39 The EPA: "will also have the power to require an audit as a pre-requisite to changes in land use zoning to a more sensitive use." EPA powers in this respect will apply to prem-

B. Victoria

In Victoria, the question of voluntary environmental audits is not explicitly addressed by legislation. There is therefore nothing in the legislation to prevent voluntary audits being conducted by the management of any enterprise. However, while the audit report would remain a private document between the enterprise and its auditor,[40] it would nevertheless be vulnerable to the court discovery process and its confidentiality would only be protected to the extent that its contents are subject to legal professional privilege.

The question of legal professional privilege is a complex one which has been addressed elsewhere.[41] However, it should be noted that in the absence of legislation protecting confidentiality it may be "impossible to predict with certainty that, regardless of the precautions taken, audits will remain protected against subsequent discovery."[42] As indicated above, this is a most undesirable result, for in the absence of guarantees of confidentiality, corporations may be most reluctant to undertake audits for fear that the contents of audit papers could be used in criminal proceedings against them. It is precisely for this reason that New South Wales has determined to extend the doctrine of professional privilege to protect all voluntary audit documents. Thus there is a significant difference between the current Victorian system, and that proposed for New South Wales.[43]

In contrast to voluntary audits, compulsory audits are expressly provided for by legislation. The *Environment Protection Act*[44] specifies that such audits may be conducted by an independent auditor (chosen from the EPA's listing).[45] Statutory audits can be mandated in a number of circumstances which relate either to industrial facilities or to contaminated land.[46] Here we focus on the former.

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ises which are subject to EPA licensing or where there are "reasonable grounds" to believe that the site has been, or is likely to be, contaminated, above n35 at 1.11.2.

40 Alternatively, the audit might of course be conducted "in house".

41 Mann, above n7; Ibbotson, above n4.

42 "Environmental Compliance Programs and Environmental Auditing", (1991) 1 *Australian Pollution Law* at 481. See also *Corporate Affairs Commission NSW v Yuill & Ors* (1991) 172 CLR 319 in which a claim of professional privilege was rejected. It is arguable that s55(3) of the *Victorian Act* is modified by the operation of the common law privilege against self incrimination; even in non-judicial contexts. See *Pyneboard v TPC* (1982-3) 152 CLR 328 at 335, 341; *Caltex Refining v SPCC* (1991) 74 LGRA 46; *Controlled Consultants v Commissioner for Corporate Affairs* [1984] VR 137. However, the law on this issue is unclear and while serious doubt exists as to the extent of legal privilege, a significant disincentive to the commissioning of voluntary audits remains.

43 However, in practice, the Victorian Environment Protection Agency (EPA) does not require notification either of the voluntary corporate audit process or of its findings. Cf the effect of the *Environment Protection Act* 1970 (Vic), s57AA with respect to contaminated land, and the recent summary by Buckley, R, "Environmental Audit and Legal Professional Privilege", (1991) 8 *EPLJ* 338.

44 Sections 4, 20(9)(C), 31C, 57, 57AA.

45 Section 57(1), *Environment Protection Act (Vic)*. The Environment Protection Authority (EPA) has its own team of environmental auditors registered under the Act. It's main functions are to assess the quality of audit reports prepared by private consultants, and to conduct cooperative voluntary audits with corporations (such as those recently carried out at Dulux and Dow). Source: Interview, Frank Smith, VEPA Auditor, 26 August 1992; *EPA Victoria, Annual Report 1990-1991* (1991) at 25.

Statutory audits of industrial facilities can be required in a number of circumstances. First, such an audit can be required as a term or condition of licence amendment[47] or of the issue of a pollution abatement notice,[48] provided in each case that the EPA is satisfied that such an audit is warranted. A statutory audit must be conducted by an independent auditor appointed by the EPA,[49] and the results submitted to the EPA.[50] It is open to the EPA to take enforcement or other action following its review of the audit findings.

The first case of an environmental audit being mandated under this procedure occurred in May 1990, when the agricultural chemicals manufacturer Nufarm was served a notice of licence amendment by the EPA requiring the conduct of such an audit.[51]

An alternative and more convoluted mechanism whereby a statutory audit may be required in respect of an industrial facility, is via s31C of the Environment Protection Act. The assumption underpinning s31C is that some industries (for example, the carbon black industry) are by their nature more likely to have a major impact on the environment and that the EPA should require of these industries a greater degree of responsibility and care. The preferred device to achieve this is the Environmental Improvement Plan (EIP). Under s31C, the Minister, on the recommendation of the EPA, can "declare" an industry, giving it, as we shall see, substantial incentive to develop and implement an EIP.

The components that must be included in an EIP are specified in s31C(6), and include compliance with any relevant State Environment Protection Policy, industrial waste management policy, regulations and licence conditions; emission and waste production standards for the industry; requirements for monitoring; provision for community participation in performance evaluation under the plan; provision for the upgrading of plant and equipment and for the assessment of new or emerging technology; and provision for contingency or emergency plans. An EIP is intended to "encourage individual firms to identify opportunities for improved environmental performance"[52] and to enable the EPA to achieve environmental improvements in addition to compliance with licence conditions.[53]

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46 Ministry for Planning & Environment, "Rezoning of Industrial Land — Environmental Conditions", 9 October 1989. With regard to the question of potentially contaminated land, where audit's role is to help identify contaminated sites and to develop clean-up plans.

47 Audit by means of licence amendment is possible under s20(9)(c). It is expressly provided for by s31C(4)(a). Section S20(6) allows the EPA to grant a licence "subject to such conditions as the Authority considers appropriate".

48 Section 31A(2).

49 The EPA released a list in April 1992 indicating that under s57(1) of the Environment Protection Act it had appointed seven persons as "Environmental Auditors — Industrial Facilities" for the purposes of the Environment Protection Act (valid until 30 November 1992).

50 See s31C(4)(b). The Nufarm audit report by Camp Scott Furphy Ltd is freely available at the VEPA Library.

51 EPA, 1990, *Licence Amendment*, 9 May 1990.

52 Parliament of Victoria, *Hansard*, (Legislative Council) 17 November 1989, 1537.

53 Typically Environment Improvement Plans (EIP) are concerned with issues that are not enforceable in a technical sense, such as employee environmental awareness training and noise reduction below that specified in schedules. The components of a typical EIP are included in VEPA *Environmental Audit: Draft Industrial Facility Auditing Guidelines*

However, a "declared" industry which refuses to develop an acceptable EIP, or an individual firm which either refuses to agree to be bound by its industry's plan or fails to adhere to its provisions, faces a less palatable alternative: namely to be made subject to the mandatory auditing requirements of s31C(4). Section 31C(4) provides that where the industry or firm in question is a scheduled premises[54] under the Act, then the Authority may amend their licence to require the occupier of the premises to conduct an environmental audit and to publish the results of that audit (usually in a local newspaper), together with the results of any monitoring program required under the Act.[55]

Any s31C(4) audit will theoretically involve "a vigorous review of the firm's premises to check for environmental contamination, to pin-point areas where wastes and emissions can be further reduced and to highlight any substandard practices or pollution control equipment."[56] Audits must be conducted by an independent environmental auditor appointed under the provisions of the Act.

To date, only two industries have been "declared" under s31C(1)[57] and there is no case as yet in which s31C(3) has been invoked to require an audit via the EIP process. Audits mandated under the licence amendment or pollution abatement notice options are also extremely rare. Indeed, the Nufarm audit is the only audit of an industrial facility that has been mandated in Victoria since the amendment of the *Environment Protection Act* in 1989.[58]

At the conclusion of an audit of industrial premises, auditors issue a report, a copy of which goes to the company and to the EPA, accompanied by an "action plan" drawn up by the company detailing how it plans to meet the recommendations of the audit. The concept of an "action plan" is not mentioned specifically in the Act, but has developed informally.[59] In response to the findings of the audit, the EPA may decide to amend the licence conditions or to issue notices such as a pollution abatement notice. However, the Act

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(1992) at 7.

54 Section 31C specifies that the section applies to Schedule 1-5 premises.

55 Audit publication is required by s31C(4)(b); firms not "scheduled" may be made the subject of audit requirements under pollution abatement notices.

56 Horsman, D, "State Regulations Imposing Liability — What are the Latest Developments? The Victorian Environment Protection Act" (1990), unpublished paper. (EPA, *Information Bulletin: Environmental Audits — Industrial Facilities*, (1991) WM91/08, at 2).

57 These are the carbon black industry and the agricultural chemicals industry as defined in the *Agricultural Chemicals Act* (1958). The ag-chem industry was declared in the *Gazette* 16 May 1990 at G19. As there is only one firm operating in the carbon black industry in Victoria, it is the company, Cabot Australasia P/L, which has been required to prepare an EIP. This declaration of the industry under s31C followed the successful prosecution of Cabot by the EPA in March 1991, over a licence breach and an air pollution offence. See EPA, above n45 at 59. Other industries likely to be "declared" include the chemical industry, the petroleum refining industry, the waste treatment industry and abattoirs.

58 The "environmental audit of Nufarm" refers to the statutorily mandated audit that followed the raid by Greenpeace on Nufarm's facility in Melbourne in May 1990. This audit was required by means of amendment of Nufarm's air pollution licence conditions under s31C(4)(a) of the *Environmental Protection Act*. See, Rae, I, Bolto, B, Gough, M and Smith, A, Report of the Reference Panel Appointed to Review Studies of the Impact of Nufarm Ltd. on the Environment, (1991); Greenpeace Australia Ltd, The Nufarm Report, (1991).

59 This concept was first developed for the Nufarm audit. Reference Panel, above n58 at 20. Source: Interview, Bruce Dawson, EPA Audit Team, 5 December 1991.

does not give the recommendations of the audit the force of law and the EPA is not required to act in response to its recommendations.[60]

The Victorian legislation also provides for the licensing and conduct of auditors. Specifically, a listing of licensed environmental auditors is maintained by the EPA Authority.[61] These persons are permitted to conduct statutory audits of both firms and contaminated sites, under the terms of the *Environment Protection Act*.[62] An expert board oversees the appointment and licensing of auditors. Other persons may be operating in Victoria under the title of "environmental auditor", but the audits performed by such persons are commissioned for commercial purposes not related to the mandatory audits provided for under the Act.

When conducting an audit, auditors are required to consider the auditing guidelines published by the Authority.[63] They must pay a licence fee to be registered for one year, and re-apply for their licence annually. Further, fines of up to $20,000 and 2 years' imprisonment can be levied against auditors convicted of misconduct such as misleading the Authority or deliberately withholding information from the Authority.[64]

Finally, the EPA has established its own audit team (as distinct from third party consultants[65]) which may now conduct audits of industrial facilities, develop environmental auditing guidelines and review the results of audits submitted to the EPA. It will also gather information for its own licensing purposes. A facility audit conducted by the EPA itself is likely to consist of an assessment of: compliance with statutory requirements, the amount and nature of wastes generated, the environmental impact of the disposal of wastes, waste minimisation opportunities, soil and groundwater contamination, and company environment policies and management practices.[66]

The Victorian audit team is the first to be established by any government in Australia. At the time of writing the team had only very recently become operational, and only time will tell us the extent and the effectiveness of the audit team's activities.

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60 Section 31c is silent on the question of enforcing the recommendations of a mandatory audit. A different system applies to audits of contaminated lands, whereby auditors are empowered to issue "certificates of environmental audit" to certify that sites are "clean". Section 57AA (ss104). Note, however, that the wording of the legislation seems to allow a different interpretation, permitting the use of such certificates for any segment of the environment, and therefore including any industrial facilities that may have been audited.

61 Section 57.

62 Note that only individuals, not corporate bodies may be environmental auditors, under the terms of the Act. See EPA Audit Team, *EPA Information Bulletin: Environmental Audits — Industrial Facilities* (1991) WM/91/08.

63 Section 57AA(3). VEPA, above n53.

64 Section 57AA(6), (7). 200 penalty units. A penalty unit is currently $100.

65 Above n45 .

66 Bazelmans, J and Smith, F, "Environmental Auditing: The Approach in Victoria" in *Proceedings of ANZECC Workshop on Environmental Auditing* (1991) EPA, Vic, at 18. See also EPA Audit Team, "*Environmental Audits — Industrial Facilities*", (1991) *EPA Information Bulletin* WM/91/08; the first two such audits were conducted over a three-month period at Dow Chemical (Australia) Ltd, and Dulux Ltd.

C. *Other jurisdictions*

Elsewhere in Australia, the question of environmental audit, mandatory or voluntary, has not been seriously addressed. There is as yet no explicit reference to environmental audit in the statutes of the Commonwealth, Queensland, South Australia, Tasmania, Western Australia or the Northern Territory. It may be that in some of these jurisdictions, some forms of audits might be invoked by implication from certain existing provisions.[67] However, these are in every case untested and the relevant regulatory authorities have indicated no enthusiasm for exploring their possibilities.

However, as indicated above, a number of these jurisdictions are contemplating creating Environment Protection Authorities and revamping their existing environmental legislation. It seems likely that some at least, will follow the example of Victoria and New South Wales by explicitly incorporating provision for environmental audit. South Australia, for example, has raised the issue of environmental audit directly in its proposals for an EPA,[68] and there is also scope for the use of environmental audit by the Commonwealth EPA.[69]

It may well be that the unanimous recommendation of the ESD Manufacturing Working Group in November 1991, is indicative of future legislative thinking on environmental audit. The Group recommended:

> that all environment protection agencies consider acquiring the reserve power to require both private and public sector organisations to undertake environmental compliance audits at their cost— and implement improvement plans where necessary. These requirements to apply where there are reasonable grounds to suggest failure to comply with the organisations' environmental obligations. The scope of such audits should be set out beforehand.[70]

4. *Realising the Potential of Environmental Audit*

It is obvious that in Australia only the first tentative steps have been taken to develop the use of environmental audit by legislative means. In its present forms, audit is capable of making, at best, only a very modest contribution to an overall environmental regulatory strategy. However, this need not be so. Environmental audit, reinforced by an appropriate legislative and enforcement strategy, can and should play a far greater role in environmental protection

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67 *Environment Protection Act* 1986 (WA) s48; *Environmental Assessment Act* 1982 (NT), cl15 of Administrative Procedures. See further Buckley, above n9 at 129. Note that these Acts refer to EIA audits and not pollution control or compliance audits.

68 SA Dept of Planning and Environment above n30.

69 Dept of Arts, Sport, Environment, Tourism & Territories (DASETT), *Proposed Commonwealth Environment Protection Agency: Position Paper for Public Comment*, (1991). For discussion/critique see Fowler, "Federal EPA", (1991) National Environmental Law Association — Environment Institute Australia — Environment Defencer's Office (NELA-EIA-EDO), above n29 at 45, 50. See also Rutherford, P, "The Relationship Between Commonwealth and State EPAs: A Conservation Organisation's Perspective", (1991) NELA-EIA-EDO, above n31 at 109-14.

70 Ecologically Sustainable Development Working Groups, *Final Report — Manufacturing*, (1991) at 156, Recommendation 49.

than has so far been the case. Indeed, if the movement away from "command and control" regulation and towards more flexible economic mechanisms continues,[71] then environmental audit may well become the central means of monitoring compliance.

In this section, we explore different approaches to environmental audit and through these we identify both its limitations and its considerable potential as a regulatory mechanism. Drawing from overseas experience, most notably the USA and the European Community, we argue that a bolder and more imaginative use of audit could make it an important and integral component of the environmental regulator's toolkit. In particular, the prudent use of audit in appropriate circumstances could enable regulators to make more efficient use of scarce enforcement resources, to glean useful (and otherwise unavailable) information about an entity's environmental behaviour, provide a means of offsetting regulatory costs, of heightening companies' awareness of environmental hazards and promoting better environmental behaviour, and of providing incentives to comply with legislative requirements. As such, environmental audit could become an important part of the overall regulatory mix.

Below, we identify six principal *means* by which environmental audit might be incorporated within a broader (environmental) regulatory strategy. However, before exploring these means in detail, it is important to understand the different *types* of audits and the purposes for which they may be used. In particular, it is important to distinguish between:

(a) auditing which is *management-driven*, that is, initiated voluntarily (and privately) by a corporation (a) to alert management to non-compliance with its legal responsibilities, or (b) to assist management to act in accordance with sound management principles; and

(b) auditing that is *enforcement-driven*, that is, required by a regulatory agency either (i) as a means of facilitating compliance with statutory requirements, or (ii) as a means of compelling industry to estimate and publicly disclose certain toxic emissions.

(c) auditing which is activated by a third party such as a purchaser or financier.

In this article, which is concerned principally with environmental auditing of industrial facilities rather than upon contaminated sites or insurance audits, the focus is necessarily on (a) and (b) above. Of the six approaches to environmental audit examined below, the first three are management-driven, while the latter three are enforcement-driven.

A. Audit by subsidy

One approach to audit which is understandably supported by industry itself, is that audits should be encouraged by means of government subsidies. For example, a paper released by the Australian Chamber of Manufactures in 1990 called upon the Federal Government to make financial support available for

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71 See, eg, Anderson, T and Leal, D, *Free Market Environmentalism* (1991); Funk, W V, "Free Market Environmentalism: 'Wonder Drug or Snake Oil?'" 15 *Harv JL & Pub Pol* (1992) at 511.

companies performing environmental audits and introducing environmental management schemes.[72] Similarly the Draft Report of the Manufacturing Working Group Report in the recent ESD process suggested that a greater number of corporations would wish to have audits performed should they be given guarantees of some form of financial concession or indirect subsidy from government.[73] These sorts of proposals have already been taken up by the Federal Department of Primary Industries and Energy (DPIE) which in July 1991 introduced a scheme to subsidise companies performing energy consumption audits.[74]

In our view, there are sound reasons why subsidies should not become the vehicle through which audits are encouraged. In economic terms, it is important to achieve "efficient" resource allocation by ensuring that firms "internalise externalities" thereby ensuring that the "polluter pays" (ie that the costs of pollution are borne by the producer or the users of the product rather than by the taxpayer or by those who live in the vicinity of the polluting enterprise). In economic terms, this will create the correct incentives for industry to reduce the costs flowing from pollution, or at least to raise the price of goods produced by hazardous industry to reflect their full social costs.[75]

B. "Pure" voluntary audits

Together with audit by subsidy, this is the least interventionist of the various forms of audit available. Representative of this approach is the USEPA's Environmental Auditing Policy Statement,[76] which encourages regulated entities to implement auditing programs but neither compels such audits nor specifies how an entity should perform an audit.[77] Similarly, a paper released by the International Chamber of Commerce in 1989 argues that:

> The broad purpose of Environmental Audits is to provide an indication to company management of how well environmental organisation systems and equipment are performing. If this purpose is to be fulfilled with full cooperation and commitment of those involved, *it is essential that the procedure should be seen as the responsibility of the company itself, should be voluntary and for company use only.* Thus audits would not normally be used to instigate prosecutions or litigation.[78]

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72 *The Age* 20 July 1990 at 5.

73 Ecologically Sustainable Development (ESD) Manufacturing Working Group *Draft Report* (1991) at 135-139.

74 Under the scheme Federal Department of Primary Industries and Energy offers organisations up to $5,000 per audit or 50 per cent of the cost of an energy audit, whichever is the lesser amount. Organisations must choose an auditor from the Register compiled by the Institution of Engineers, Australia. Such an audit will assist organisations to identify and then exploit opportunities for reducing energy use and greenhouse gas emissions. *Dept of Primary Industries and Energy* (PIE), Media Release, 2 July 1991.

75 In general (depending on demand elasticity) an increase in price leads to a decrease in output which therefore indirectly decreases the level of pollution.

76 51 Fed Reg 25004 9 July 1986.

77 For example, the only concession EPA makes to encourage environmental audits is to promise not to request the results of such audits routinely but it will not give undertakings that it will not attempt to discover relevant audit material if germane to specific enforcement activities. Van Cleve, "The Changing Intersection of Environmental Auditing, Environmental Law, and Enforcement Policy" (1991) 12 *Cardozo LR*, 1215 at 1223.

78 International Chamber of Commerce, above n9 (our emphasis).

Within Australia, voluntary audits are entirely unregulated (although changes have been foreshadowed in New South Wales and South Australia)[79]. As we have seen, this *laissez-faire* approach creates significant disincentives to conducting an audit, in terms of court ordered discovery of audit documents.[80]

Nevertheless, three trends within environmental law and practice have increased the preparedness of industry to undertake voluntary environmental audits even without *direct* incentives provided by government policy or legislation. The first is the perception on the part of business of an increasing willingness of enforcement authorities to prosecute for breaches of environmental law, coupled with the threat of higher penalties.[81] The second is the increased tendency to make individual corporate officers responsible for such breaches. So for example, in both New South Wales and Victoria, directors and managers must prove that they exercised "due diligence" in order to avoid liability for certain serious offences,[82] while the NSW EPA also requires a Certificate of Compliance to be signed by the chief executive officers of licence holders on annual renewal of licences.[83] The third trend is increasingly strict statutory obligations on corporations to mitigate, abate and clean up pollution.[84] As a result of these trends, corporations are turning to environmental audits (appropriately implemented) as a means of identifying compliance shortcomings and shielding management from liability under environmental protection legislation.[85] Such audits also heighten management awareness of environmental hazards, and make it easier for management to identify risks and hazards, to control environmental practices and to substantially improve environmental performance.

Yet despite these undoubted virtues, the question remains: Is the "pure" voluntary approach alone entirely adequate or should government also intervene more directly to curb environmental degradation by providing for incentive-based and/or mandatory audits?

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79 Above n3; eg, in SA an expert committee has been considering the potential role of audit under the *Environmental Protection Act*. A draft of the Act proposes (1) the protection of confidentiality of voluntary corporate audits, (2) a reserve mandatory audit power for instances of persistent non-compliance. Source: Interview with Fowler, R J, 12 August 1992.

80 Above n40. However, an environmental audit may *increase* the potential liability of directors by making them more aware of the environmental problems of the company.

81 These include maximum penalties of $1m in some jurisdictions for serious offences perpetrated by corporations. See *Environmental Offences and Penalties Act* 1989 (NSW) s8; *Environment Protection Act* 1970 (Vic) s59E. For discussion of the accuracy of this perception see: Farrier, D, "Criminal Law & Pollution Control: the Failure of the *Environmental Offences and Penalty Act* 1989 (NSW)" (1990) 14 *Crim LJ* 317; Lipman, Z, "Criminal Liability Under the Amended *Evironmental Offences and Penalty Act* 1989 (NSW)" (1991) 8 *EPLJ* 322; Chappell, D and Norberry, J, "Deterring Polluters: the Search for Effective Strategies" (1990) 13 *UNSWLJ* 97.

82 See *Environmental Offences and Penalties Act* 1989 (NSW) s10; *Environment Protection Act* 1970 (Vic) s66B.

83 Court, above n3.

84 See *Environmental Offences and Penalties Act* 1989 (NSW); *Environmentally Hazardous Chemicals Act* 1985 (NSW); *Clean Waters Act* 1971-1978 (Qld); *Waste Management Act* 1987 (SA); *Public & Environmental Health Act* 1987 (SA); *Clean Air Act* 1984 (SA). See above n18.

85 For example, directors cannot claim to have exercised "due diligence" unless they have made themselves aware of the existing and future liabilities of the company.

The USEPA Policy Statement itself expressed strong preference for an exclusively voluntary approach, principally "because audit quality depends to a large degree upon genuine management commitment to the program and its objectives".[86] Certainly there are circumstances where enlightened (long-term) self-interest may induce companies to undertake audits voluntarily. Corporate concerns with minimising environmental liability, with maintaining public image, with anticipating or pre-empting legislative proscriptions, with generating more efficient operating practices (which in some circumstances may be compatible with improving environmental standards) and a variety of other factors may all make it economically rational to engage in "compliance" and broader "managerial" audits.[87]

Equally there are circumstances where companies have no economic self-interest in conducting audits and remedying problems, where it is cheaper to "externalise" the costs of environmental degradation onto workers, local residents, taxpayers and future generations, than to sacrifice corporate profits, shareholders' dividends or market share. Under these conditions, the public interest and private interest diverge, and mechanisms are required to induce and, if necessary, compel recalcitrant corporations to comply with their legal obligations. In those circumstances, incentive-based or mandatory environmental audit can make an important contribution in a way that purely voluntary mechanisms cannot.[88]

In making this argument, we are not suggesting that all firms always behave with rationality. Indeed there is considerable evidence that they do not.[89] However, this in no way diminishes the need to look beyond voluntary audit. For example, voluntary audits would be equally inadequate in dealing with incompetents: those firms for whom it is economically rational to conduct voluntary audits but who fail to do so. Thus there is a case for going beyond voluntary audit, both in terms of economic rationality, and for other reasons.

On this view, both voluntary and mandatory compliance have their place. Voluntary compliance (ie, management initiated audits) is appropriate (and compulsion counter-productive)[90] in circumstances where public and private interest largely coincide. Here, management goodwill and cooperation is worth cultivating, and the benefits of voluntary audit in terms of raising man-

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86 See 51 Fed Reg 25007 9 July 1986. Current EPA policy is that it will make direct use of audits only in consent decrees and settlement negotiations. The EPA Policy also argues that a voluntary approach is preferable "because environmental auditing systems have been widely adopted in the past". However this statement is empirically unproven in the USA, and probably inaccurate in Australia. See further Van Cleve, above n77 at 1220 . Moreover, the EPA's assertion is very much at odds with the considerable experience of auditing in the financial arena, where management commitment is clearly not a prerequisite to a successful audit. On the relationship between financial audit and environmental audit, see Van Cleve, id at 1232-7.

87 Brown, above n6 at 5-6.

88 Braithwaite, J, "Policies in an Era of Regulatory Flux" in Head, B and McCoy, E, *Deregulation or Better Regulation* (1991) 23 and above n15.

89 Mokhiber, R, *Corporate Crime and Violence: Big Business Power and the Abuse of Public Trust* (1988).

90 Compulsion in these circumstances creates an unnecessary adversarial relationship between business and government and may spawn a culture of regulatory resistance: Bardach, E and Kagan, R, Going by the Book: the Problem of Regulatory Unreasonableness (1982).

agement environmental consciousness, identifying environmental problems of which regulated entities were unaware, and of prompting voluntary action, may be considerable. However, where there is a large gap between public and private interest (eg, when companies have no economic incentive in remedying environmental problems), or where firms behave irrationally or incompetently, then voluntary measures are likely to be either non-existent or ineffective and largely cosmetic.[91] It is in these circumstances that other forms of environmental audit must be explored.

C. *Incentive-based schemes*

There are two main types of incentive-based schemes. The first involves a government undertaking to regulate more lightly, those firms which voluntarily enter an audit scheme. The second involves providing substantial credibility and public relations benefits to participating firms. As we will see, some schemes incorporate both of these elements.

So far as the first of these strategies is concerned, it is clear that regulatory agencies have considerable discretion in enforcing the legislation for which they are responsible. Such agencies might choose to exercise that discretion in ways which provide regulated entities with incentives to undertake environmental audits. Specifically, they might choose to adopt an enforcement strategy whereby companies which *voluntarily* undertake environmental audits, disclose their results to the agency, *and* take effective action, are subject to less frequent inspection and lighter regulation than those who do not.[92] Alternately, companies might be put on notice that if they fail to implement appropriate internal mechanisms, then harsh penalties may be imposed where violations occur which such internal mechanisms would have prevented or (put more softly) that auditing may be viewed as a mitigating factor in exercising environmental enforcement discretion.

By invoking such a strategy, an agency could provide considerable incentives to regulated enterprises to conduct audits voluntarily. Such audits (if truly independent and externally verified)[93] may provide the agency with much valuable information about the regulated entity's affairs which (given scarce monitoring resources) is not otherwise available, and would alert both the company and the inspectorate as to any need for environmental improvements.

However, such information could not sensibly be used as a basis for enforcement action, for if it were, few, if any, companies would agree to participate in the scheme.[94] More appropriately, the agency might undertake to give participating firms a "period of grace" to rectify problems revealed by the

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91 Data supplied by the industry as to its own performance may be unreliable, and the potential for an "independent" auditor to be "captured" by its client is considerable.

92 For example, under the US Occupational Health and Safety Administration's Voluntary Protection Program, successful applicants are no longer subject to routine inspection. See references at n98 below.

93 This assumes independent auditors, themselves appropriately monitored. See Australian Conservation Foundation — World Wildlife Find (ACF-WWF) (1991) *Assessment of the ESD Working Group Reports*, at 115-117.

94 There is, after all, little incentive to conduct an audit if the information it generates serves to provide a basis for prosecution or other enforcement action.

audit, before resuming any surveillance of the firm's activities.[95] Indeed, any agency wishing to encourage incentive-based voluntary audit might be well advised to follow the stated policy of the US Federal Aviation Agency:

> I am announcing a major change in the FAA's enforcement policy. Simply stated, it is this: if you discover an inadvertent violation, correct the problem, report it promptly to the FAA, and put in place a permanent fix acceptable to FAA to make sure it will not happen again, the FAA will not penalize you ... *Period.*
>
> In other words, we want to encourage carriers to shift their resources from contesting punitive enforcement actions to making their operations safer. Internal evaluation promises to benefit the aviation industry and the FAA by allowing each of us to use our resources more positively, intelligently and effectively.[96]

Despite the advantages of incentive-based audit, it has been argued that such a system of incentives is so "fraught with legal and policy obstacles" that most companies "would not support or participate in an incentives-based environmental auditing program".[97] However, this view is contrary to the empirical evidence. There are precedents for the success of such a policy in the related area of occupational health and safety,[98] and in the existing environmental audit systems of some European countries. In Holland, for example:

> Companies which do not have an efficiently operating environmental management system at their disposal will in the Government's view be sooner considered for intensified enforcement activities by competent enforcement authorities relative to companies which are trusted to have an efficiently operating environmental management system.[99]

However, it must be acknowledged that only companies which are firmly committed to cleaning up problems which an audit might identify, are likely to participate. There are two main reasons for this. First, although regulatory

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95 It might be necessary to provide statutory guarantees that information gathered in such an audit *cannot* be used in any subsequent prosecution action. Such a strategy would work most effectively if the relevant inspectorate adopted a diagnostic role — at least in respect of voluntary audits. That is, it would see its primary means of obtaining compliance as the provision of technical assistance to companies in breach of regulatory standards, keeping advice and policing as quite separate functions. See further Braithwaite, J and Grabosky, P, *Of Manners Gentle: Enforcement Strategies of Australian Business Regulatory Agencies* (1986).

96 Busey, J B, Administrator, Federal Aviation Administration before the Aero Club of Washington DC (27 March 1990) cited in (1991) 12 *Cardozo LR* 1327. For a variation on this theme, see generally Ennis, P J, "Environmental Audits: Protective Shield, or Smoking Guns?" (1992) 42 *Washington UJ Urban and Contemp Law* 389.

97 USEPA, *Environmental Auditing Policy Statement*, 51 Fed Reg 25004 9 July 1986, reprinted in UNEP (1989) at 107, see 108. The main objection, as the USEPA has argued, is that a reduction of enforcement efforts or inspections for those who perform environmental audits would eliminate the current incentive for them to perform effective audits and correct deficiencies (at 113).

98 See Rees, J, *Reforming the Workplace: A Study of Self-Regulation in Occupational Health and Safety* (1988); Pendergrass, J and Pendergrass III, J, "Beyond Compliance: A Call for EPA Recognition of Voluntary Efforts to Reduce Pollution" (1991) 21 *Env LR*, 10305.

99 Documents, Lower House (Parliament) 1988-9, 20633, nr 3, Internal Company Environmental Management. Summary of the note for Dutch Lower House, English translation, 30 August 1989 at 3.

agencies may provide a "period of grace", in the long term, having been alerted to the existence of a hazard, they are likely to insist on its removal. Secondly, information passed on to the regulatory authorities as a result of audit may, in some jurisdictions, become publicly available through the operation of Freedom of Information Legislation.[100] As a result, it could readily cause adverse publicity and damage the company's public image or even form the basis for third party legal action ("citizen suit") against the company. This latter problem, at least, could be overcome if the confidentiality of such audits were expressly preserved as between the firm and the regulatory agency. On balance, despite our general support for the principle of "right-to-know", we believe such confidentiality protection is necessary in this context[101] in order to avoid deterring voluntary audits.

A second type of incentive-based audit has recently been adopted by the European Commission, and is known as the "voluntary community eco-audit scheme". Firms which agree to participate in this scheme must carry out an initial environmental review of the site's activities and, in the light of its findings, implement an "internal environmental protection system" aimed at achieving a high level of environmental protection. This must include, in writing, an environmental policy, environmental objectives and targets, an environmental program and an environmental management system which includes an audit every one to three years depending on the environmental impact of the site's operations.[102]

Participating firms must also provide a regular environmental statement detailing their activities, the major environmental issues these activities raise, a summary of pollution emissions and waste generation, and an evaluation of overall environmental performance. This statement is intended to inform both the authorities and the public of the firm's activities.[103]

The audit itself may be carried out either by the company's own staff or by outside auditors, but in either case independent accredited environmental verifiers must accredit the procedures adopted and certify the statements made available to the public.

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100 *Freedom of Information Act* (Cth) 1982, s11, but noting the exemptions in Part IV of that Act. The scope of some exemptions of particular relevance to matter supplied by business to government has been considered in *Searle Australia v Public Interest Advocacy Centre and Dept Community Services and Health* (1992) 36 FCR 111, in particular the meaning of "trade secrets" in s43(1)(a), and the scope of s45 (breach of confidence).

101 Except where the regulated entity chooses to rely on some or all of those results to establish in court that it exercised "due diligence" in which case the issue of confidentiality would be at the discretion of the court.

102 Reuter News Service, "Commission Seen Settling Main Eco-Audit Issues", 17 December 1991. Commission of European Communities, Spokesman's Service, "Commission Proposes Voluntary Community Environmental Audit Scheme for Industry" 19 December 1991, at 1.

103 "Commission Changes Track on Environmental Auditing", ENDS Report No 194 March 1991 at 33-34. An early draft required that "a statement shall fully and objectively reflect the audit results and shall address all the issues arising from the audit". However, while the current version lays down a more comprehensive list of areas to be covered by the public statement than previous versions, it also allows it to deal with the company's environmental policy and aims in fairly general terms rather than making it concentrate on audit findings.

Firms which participate in the scheme earn the right to use an eco-audit logo on their environmental statements, on the company's brochures, reports and information documentation, and for the company's advertisements, provided they contain no reference to specific products or services. The incentive basis of the scheme, according to the Commission, is that joining it will:

> improve firms' standing and credibility with the public, shareholders and the authorities. In the long term, all this promises economic advantages and an improved image. For this reason, the Commission feels that firms participating in the eco-audit scheme will find the cost-benefit balance significantly to their advantage.[104]

It may be that a further incentive will be offered to participating firms, at the option of member States, namely that:

> Member States may simplify requirements concerning inspection and control by competent authorities for those companies registered under the eco-audit scheme and which will make the audit report available to the competent authorities.[105]

If this occurs, then a single scheme will incorporate both types of incentive described above.

It will be apparent from the above description, that the main advantages of incentive-based schemes are that they encourage firms to exceed the bare minimum required by law, and that some firms which would not otherwise participate in a voluntary scheme, are persuaded to do so. Nevertheless, like "pure" voluntarism, an incentive-based scheme will not attract those who for reasons of economic self-interest or otherwise, see no virtues in participation. The case for a mandatory component, therefore remains strong.

Moreover, there exists a tension between the desire of firms to convince the public of their environmental credentials (requiring some disclosure) and their desire to avoid revealing environmental problems or to disclose commercial confidential information. As a result, there remains a danger that such schemes will degenerate into public relations exercises for industry, whereby "environmentally audited" logos are used as a means of attracting poorly informed but environmentally concerned consumers to buy a polluter's products.[106] The misuse of "green labelling" and the recent spate of misleading advertising claims about "environmentally friendly" products[107] suggests that this possibility must be taken seriously.

Similarly, some commentators have expressed concern at the present dilution (following intense industry lobbying) of the environmental statement — the only aspect of the audit report to which the public will have access. If this in turn becomes merely a sanitised summary, then community groups and others will have insufficient information to "keep industry honest". Clearly, in-

104 See above n99. Many industry officials anticipate that pressure from shareholders, insurers, clients and the public will give big manufacturing companies little choice but to sign up from the start.

105 "Commission Changes Tack on Environmental Auditing" *ENDS Report* 194, March 1991.

106 *Financial Times* (London) 13 August 1991, at 4.

107 Holder, J, "Regulating Green Advertising in the Motor Car Industry" (1991) 18 *Journal of Law and Society* 323; Wallace-Bruce, N L, "Environmentally Safe or Environmentally Friendly: Defining the Legal Boundaries of Green Marketing" (1991) 3 *Bond LR* 187.

centive-based audit can only work in the public interest if the requirements necessary to obtain a logo are stringently stated and effectively enforced.

D. Community right-to-know

A fourth form of environmental auditing exists as an integral part of Community Right-to-Know legislation. Such legislation is as yet undeveloped in Australia. However, the Coode Island explosion[108] has now placed the issue more firmly on the Australian legislative agenda, and recognition of the need for a limited form of community right-to-know is included in the Australian Chemical Industry Council's (hereafter ACIC) "Responsible Care" Program.[109]

In contrast, the United States has had Right-to-Know Legislation for some time. The most powerful US statute is the *Federal Emergency Planning and Community Right-to-Know Act* 1986[110] (EPCRA) which has had a substantial effect on pollution control in that country. EPCRA involves various measures designed to ensure that information about chemical risks are adequately communicated to the public. Specifically, the legislation requires that manufacturers who produce or use designated hazardous chemicals must compile an inventory of the quantities of such chemicals they are using or storing at their facility;[111] they must provide both the public and the EPA with estimates of the amounts of the chemicals they are releasing into the environment annually,[112] they must supply details of accidental releases of acutely toxic chemicals;[113] and they must file material safety data sheets (MSDS) with State and local authorities in respect of each designated chemical they manufacture, use, handle or dispose of.[114] In effect, these requirements amount to a compulsory environmental audit in respect of emissions of a range of designated chemicals, many of which are otherwise not regulated.[115]

The arguments in favour of Community Right-to-Know Legislation are similar in many respects to those made above in respect of mandatory environmental audit generally. However, what distinguishes Right-to-Know from other forms of mandatory audit, is its emphasis on disseminating information to the public, and its underlying philosophy: that community groups and Non-Governmental Organisations, if empowered by sufficient information, can act as an effective countervailing force to the private interests of private enterprise.

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108 "Report on Coode Finds 400 Breaches" *The Age*, 11 December 1991 at 1; *Canb Times*, 30 August 1991 at 5; Coode Island Review Panel (1991) *Information Paper*, at 14-24; Hazardous Materials Action Group, *Unlocking the Factory Door* (1992).

109 Australian Chemical Industry Council, Community Right to Know Code of Practice (1993). On Responsible Care, see generally *Chem Wk*, 17 July 1991.

110 (1988) 42 USC 11001-50.

111 (1988) *Federal Emergency Planning and Community Right-to-Know Act* (EPCRA) (1988) ss311, 312, 42 *USC* 11021-22.

112 (1988) EPCRA ss313, 42 *USC* 11023. See also State equivalents such as California's Proposition 65. Pease, W, "Chemical Hazards and the Public's Right to Know: How Effective is California's Proposition 65?" (1991) 33 *Environment* 13.

113 (1988) EPCRA ss304, 42 *USC* 11004.

114 42 USC 11021.

115 The Right to Know More Bill, House of Representatives 2880 of 1992 (defeated in March 1992), aimed to add more chemicals to the Toxic Release Inventory program. See also 22 *Friends of the Earth Magazine* USA 6.

While the detailed arguments in favour of Community Right-to-Know legislation must be made elsewhere,[116] it should be noted that corporate decision-making with respect to toxic substances appears to have been substantially influenced by EPCRA. The mandatory provision of such detailed and comprehensive information about spills and chemical emissions, to the general public, has generated considerable public scrutiny and criticism of manufacturers' operations. For example, the first full set of filings under EPCRA suggested that a huge 2.7 billion pounds of hazardous pollutants were being emitted to the air alone in 1987.[117] These sorts of figures have not only fuelled community debate about the location and development of industrial facilities close to residential areas (now mirrored in Victoria, following the Coode Island disaster); they have also created a substantial public backlash against the least regulated emissions of industry such as, in the USA, air emissions.[118]

This backlash has prompted a number of major chemical manufacturers to reassess their own operations and to modify their environmental control strategies even in the absence of government legislation requiring them to do so. For example, both DuPont and Monsanto have made major changes in terms of phasing out hazardous products and reducing hazardous air emissions, well beyond those required by law.[119] While this response may well be based on enlightened self-interest and in part to minimise future compliance and liability costs, this in no way detracts from the effectiveness of the "Right-to-Know" strategy. It may be, as EPA Administrator William Reilly has asserted, that:

> Based on the industry response so far, it is clear that one of the most effective instruments for reducing toxic air emissions has been the Community Right-to-know law requiring industries to estimate and publicly announce them, by plant and by chemical.[120]

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116 Abrams, R and Ward, D, "Prospects for Safer Communities: Emergency Response, Community Right to Know, and Prevention of Chemical Accidents" (1990) 14 *Harv Env LR* 135; Finto, K, "Regulation by Information through EPCRA" (1990) 4 *National Resources and Environment* 13.

117 The *total* level of pollution reported in 1987 under ss313 of EPCRA exceeded 20 billion pounds. Bureau of National Affairs (BNA) *Environment Reporter* (26 April 1989 at 2628-9). See also Yost and Schultz, "The Chemicals Among Us" *The Washington Lawyer* March/April 1990 at 24. Substantial evidence exists that the extent of under-reporting of environmental pollution is widespread. See *PR Newswire* 11 December 1991; Lave, O, "Tons of Toxic Chemicals Above", (1989) *Christian Science Monitor*, 11 April 1989 at 19; BNA, *Environment Reporter*, 22 July 1988 at 399; 30 December 1988 at 1782; Poje, G and Horowitz, D, *Phantom Reductions: Tracking Toxic Trends* (1990) National Wildlife Federation, Washington DC.

118 The compilation of the national toxic release inventories between 1987 and 1990 greatly assisted environment groups to campaign for a thorough overhaul of the *Clean Air Act* in 1990; however, it must be noted that there were numerous additional pressures leading to the changes. Latin, H, "Regulatory Failure, Administrative Incentives, and the New Clean Air Act", (1991) 21 *Environmental Law Act* 1647; Millar, F, "Too Close for Comfort", Winter (1991) *Friends of the Earth* at 10; BNA, *Environment Reporter*, 24 March 1989 at 2512; 31 March 1989 at 2543-4; 12 April 1989 at 192; BNA, *Int'l Environment Reporter*, 21 November 1990 at 490-1.

119 Van Cleve, above n77 at 1233.

120 Reilly, W, "Aiming Before We Shoot: The Quiet Revolution in Environmental Policy", Address to the National Press Club, Washington DC, 26 September 1990.

Such regulation through information is made doubly effective if the citizens who have access to information about corporate and government agency pollution are granted the opportunity (1) to sue regulatory agencies for failure to enforce regulations and (2) to sue corporations if the EPA is unwilling to file suit itself.[121] In the USA, NGOs have used the public standing provisions of EPCRA to enforce compliance with EPCRA, and the court ordered settlements arising from such suits have included the requirement of conducting an environmental audit.[122]

E. Liabilities Disclosure under Corporations Legislation

For many years, corporations legislation has required:

(i) the disclosure of material information to the public concerning the company's current and projected financial position; and

(ii) for these statements to be regularly audited by an independent accountant acting according to applicable audit standards approved by law.

The assumption underpinning this legislation is that disclosure and audit together, are effective ways of protecting investors against corporate fraud and of assisting them to make appropriate investment decisions — of making markets "efficient" without need for more direct forms of government intervention.

Such requirements originated in the US in the *Securities Act* 1933 and the *Securities Exchange Act* of 1934[123] and were confined to certain types of financial information. However, in more recent times, the US Securities and Exchange Commission has extended the use of the audit mechanism so as to require the disclosure of environmental liabilities.[124] This action was prompted by the belief that a number of large corporations were seriously understating their environmental liabilities in their annual reports to stockholders, and thereby misrepresenting their total assets and overall financial position.

The current position is that publicly traded companies must prepare and disclose information specifically relating to environmental compliance and liabilities, as part of their broader disclosure obligations under the 1933 and 1934 Acts.[125] For example, regulations now require disclosure of all potential

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121 Miller, J, (1987), *Citizen Suits: Private Enforcement of Federal Pollution Control Laws*; Babich, A, (1988), "Community Right-to-know: EPCRA Enforcement for Local Governments, States and Citizens", *Chem Waste Litigation Reporter*, 777; Boyer, B and Meidinger, E, "Privatising Regulatory Enforcement: A Preliminary Assessment of Citizen Suits Under Federal Environmental Laws", (1985) 34 *Buffalo LR*, 833.

122 In March 1991 in the USA environment groups filed suit against a manufacturer for breach of the EPCRA. A consent decree settling the case was announced, which obliged IR to conduct an environmental audit and toxics use reduction measures. [Hecker, J and Padgett, C, "Right-to-know Suit Settled", 2 August 1991. Retrieved from Community Right-to-know conference on EcoNet electronic mail computer network.

123 15 USC 78a-11 (1988).

124 Geltman, E, "Disclosure of Contingent Environmental Liabilities by Public Companies Under Federal Securities Law" (1992) 16 *Harv Env LR* 129.

125 17 CFR 229. The central requirements are set out in Securities and Exchange Commission Regulations S-K. They include:"disclosure of circumstances in which environmental regulations may necessitate significant capital outlays and may materially effect the earning power of the business, and disclosure of pending proceedings arising under environmental laws."

environmental problems except those "not reasonably likely to occur"; disclosure where "there is at least a reasonable possibility that a loss ... may have been incurred"; and determinations by management which are "reasonably objective" when made.[126]

Although in the past, Australian companies have not faced any comparable requirements with respect to environmental disclosure, this situation may well be changing as a result of the *Corporations Law*,[127] which came into force in 1991. Both the new prospectus provisions,[128] the recently amended accounting standards,[129] and the existing provisions of the *Trade Practices Act*[130] have quite far-reaching implications concerning:

> disclosure of non-compliance with environmental protection legislation where the non-compliance is relevant to assessments of a company's performance or financial position.[131]

Specifically, there is little doubt that a failure to disclose a material liability or potential liability arising from environmental regulation, made in the general context of presenting the company's financial position and prospects, would constitute "misleading conduct" for the purposes of the *Corporations Law* s995 and the *Trade Practices Act* s52.[132] Further, the Corporations Law s996, which deals with false and misleading statements in a prospectus, specifically refers to a "material omission", while s1022 states that a prospectus should contain information which investors would reasonably require and reasonably expect to find in a prospectus, including a statement of liabilities.[133] As a result, investors who rely on prospectuses or financial statements which contravene these provisions may have personal rights of action against the recalcitrant company, its directors, and professional advisers.[134]

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126 54 Fed Reg 22430 and see Accounting Standards Current Text c59109, 1988, cited in Carney, above n20 at 3.

127 In particular, s1018 of the *Corporations Law* makes it obligatory to issue a prospectus when offering securities for subscription or purchase and s1022 requires prospectuses to disclose any liabilities which investors reasonably "would expect to" know and which are known either to the company or its professional advisers. See also the "due diligence" defence under s1011.

128 Specifically, the Corporations Law s995 prohibits misleading or deceptive conduct in connection with, among other things, the issue of a prospectus. Breach attracts civil liability only (s995(3) and ss1005-6). Section 996 prohibits false or misleading statements or "material omissions" in a prospectus. Breach attracts civil liability (s1006) and criminal liability (s1308).

129 Statement of Accounting Concepts: "SAC2 — Objective of General Purpose Financial Reporting" issued by the Accounting Standards Review Board and the Australian Accounting Research Foundation on behalf of the Australian Society of Certified Practising Accountants and the Institute of Chartered Accountants, in August 1990, which applies to all financial reporting periods that end after 31 August 1990, referred to in Carney, above n20 at 5.

130 Section 52 of the *Trade Practices Act* 1974 (Cth) prohibits misleading or deceptive conduct "in trade or commerce". Breach attracts civil liability only (s79).

131 Carney, above n20 at 5

132 The significance of the *Trade Practices Act* is that it is far easier to sue in respect of misleading statements or omissions than it is under the *Corporations Law*, particularly if the corporation, rather than an individual, is sued, since there is no due diligence defence, except possibly in respect of statements about future matters.

133 As the implication of environmental liability for business becomes more apparent, so also will the corresponding obligation to ascertain the extent of that liability.

134 Carney, above n20. However, note that both individuals and corporations may escape li-

Thus companies in Australia now have obligations to monitor and disclose their report on compliance with environmental legislation in a manner broadly similar to that required by the US authorities. These provisions may well accelerate the use of environmental audits in Australia as companies come under increasing pressure to gather more specific information about their actual and potential environmental liabilities.

However, the American provisions, and no doubt the Australian provisions once fully implemented, are fraught with problems of enforcement.[135] Many of the statements made by US companies to satisfy the Securities and Exchange Commission (SEC) disclosure requirements, have been castigated as "empty, perfunctory and vague",[136] largely because companies have strong *disincentives* to identifying large prospective liabilities that might well make their enterprise unattractive to prospective shareholders. Given the considerable scope for "creative accounting", the effects of which are now well documented in financial dealings,[137] there is little prospect of the new Australian provisions having a substantial impact unless there is a strong commitment to enforce them on the part of the recently formed Australian Securities Commission and in the case of s52, on the part of the Trade Practices Commission.

The absence of any clear professional standards in respect of environmental auditing or accreditation procedures will undoubtedly exacerbate the problem of effective enforcement.[138] As Herz concludes:

> [there are] very real difficulties with the concept of disclosure generally and with pinning down with any precision just what environmental liabilities exist and just how they are likely to affect the firm's business. Making that evaluation is the challenge of environmental management.[139]

How far these difficulties will be overcome in the Australian context remains to be seen. However, the experience of "Right-to-Know" Legislation suggests that at least in principle, disclosure of significant environmental data concerning a corporation's operations can influence public opinion, investment decisions, regulatory enforcement activity and the company's own priorities in

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ability in certain circumstances. In particular, a director is not liable if he or she is merely relaying an expert's report and had reasonable grounds for believing that the expert was competent and that expert had given consent for the report to be used (s1008A). However, the further requirement to exercise due diligence in checking the reasonableness of the belief (as yet untested) may imply that directors cannot passively shelter behind expert reports.

135 A survey performed in 1991 showed that the banking industry had been failing to declare any significant environmental liabilities to the SEC. All of the most recent forms submitted by the 20 largest bank holding companies failed to reveal any legal liabilities resulting from environmental protection. Of the six largest operating in the States with the largest numbers of Superfund sites, none had filed forms indicating environmental liabilities. Donahue, J, "Dodging Toxic Liability" (1991) June *Multinational Monitor* 18.

136 Herz, M, "Environmental Auditing and Environmental Management: The Implicit and Explicit Federal Regulatory Mandate" (1991) 12 *Cardozo LR* 1241 at 1256.

137 Chambers, R J, "Accounting and Corporate Morality — the Ethical Cringe" (1991) 1 *Aust J Corp L* 9; Walker, R G, "Off-Balance Sheet Reporting" (1991) 15 *UNSWLJ* 196.

138 Gunningham, N, "Who Audits the Auditors?" (1993) 10 *EPLJ* 229. VEPA, above n51 at 7, discusses that in the case of audit required by licence or notice the EPA requires production of the details of any proposed [audit] sampling program, including laboratories and quality assurance and quality control procedure.

139 Herz, above n136 at 1257.

decision-making. In this way, disclosure provisions might potentially play a significant role in curbing environmental degradation.

F. Mandatory audits

By virtue of a mandatory audit a regulated entity might be required to conduct an independent audit at its own cost or accede to the conduct of an audit by the EPA; to fully disclose the results; and to implement its recommendations by developing a remedial plan (or corporate management plan) to address the most serious problems identified by the audit.[140]

The conduct of such an audit and implementation of the auditor's recommendations might be made a condition of: a waiver of prosecution or other enforcement action; licence or licence renewal; granting of planning approval; or as part of a court-order, in addition to or instead of any other penalty imposed.[141]

What should be the role of mandatory audit? In the previous sections, we argued that voluntary audits alone will not be adequate where companies do not have the incentives, or for other reasons are not willing to comply voluntarily. In these circumstances, mandatory audits can achieve much that their voluntary counterparts cannot, particularly in making industry publicly accountable.

Mandatory audit is a potentially powerful weapon in the regulatory agency's armoury, not least because the costs to a regulated entity of being required to commission an audit, may be very considerable indeed, and are often far in excess of any likely penalty imposed by a court for breach of environmental legislation.[142] For example, the Nufarm case indicates that the costs of being required to have an environmental audit performed may reach as high as several hundred thousand dollars.[143] Once this fact is understood by industry, and provided an agency's willingness to impose audits is also known, then industry will have considerable incentive to avoid even the *possibility* of such an audit. That is, regulatory agencies will have considerable lev-

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140 Mindful of the distinction between compliance audits and management audits, experience would suggest that the former is appropriate "where the discovered violations suggest that environmental non-compliance exists elsewhere within the party's operations", while the latter should be required "when a major contributing factor to compliance is inadequate managerial attention to environmental policies, procedures and staffing"; Van Cleve, above n77 at 1229. That is, there should be considerable flexibility in determining the appropriate scope of any individual audit.

141 *US v Menominee Paper Co Inc and Bell Packaging Corp*, 727 F Supp 1110 (1989), (required the creation of a date specific timetable by an external auditor, for the implementation of audit recommendations); *US v. Eagle-Picher Industries*, Civ Action No 87-5100-CV-SW-8 (WD Mo 12 July 1990) Fed Reg 28,694; cited Van Cleve, above n66 at 1230-1. Price, C M and Danzig, A J, "Environmental Auditing: Developing a 'Preventive Medicine' Approach to Environmental Compliance" (1986) 19 *Loyola LA LR 1189*; *Proceedings of Symposium on Environmental Litigation and Enforcement*. See 1203-1211; *US v Ethyl Corp*, cited Louisiana Industry Envt Alert, August 1991, Vol 6, No 96, *Env Compliance Reporter*.

142 Current fines in Victoria are usually in the order of a few thousand dollars, if not replaced by a good behaviour bond and imposition of costs: EPA, above n43 at 58-60. Victoria, Auditor General, *Report on Ministerial Portfolios* (1991) 53 at 65.

143 "Mr Rathbone [of Nufarm] estimated the total cost of the exercise to Nufarm at $5-6 million — $1 million in studies, including $200,000 for the environmental audit, and $4-5 million because of lost production." *Australian Financial Review*, 3 May 1991 at 39.

erage in achieving compliance, even when (as is common at present) they are very reluctant to pursue prosecution, whether because of very limited enforcement resources (prosecutions are costly both financially and in terms of personnel) or because the level of penalties imposed by the courts is dispiritingly low.[144] Faced with a recalcitrant polluter, an agency may find that the mere suggestion that the agency is contemplating mandating an audit may be sufficient to induce compliance.[145]

Moreover, while the confidentiality of audit results may be a necessary prerequisite for an effective "pure" voluntary audit program, this is not so for mandatory audits. Indeed, the successful operation of the latter largely depends on the public disclosure of the audit results.[146] Such disclosure gives companies strong incentives to improve their environmental performance for fear of bad publicity, while at the same time placing pressure on the relevant regulatory agency to take appropriate action against serious offenders since its actions (and inactions) will be subject to public scrutiny.

However, it must be noted that serious and as yet unresolved questions arise as to the extent to which commercial confidentiality and trade secrets should be exempt from disclosure. If the experience of occupational health and safety legislation is repeated, then some companies will interpret the "trade secret" exemption very broadly, using it to avoid disclosure of a wide range of material information.[147]

Mandatory audit could take a number of forms. At one extreme it would involve a legislative requirement that each enterprise in an entire industry or industry sector conduct (or have conducted by an independent auditor) an audit addressing issues prescribed in the legislation. The European Commission's 1991 discussion paper (subsequently abandoned) which contemplated mandatory self-assessment for 58 types of industry — public reporting in annual environmental statements and external verification by independent regis-

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144 For an analysis of those factors and others in the related field of occupational health and safety, see Gunningham, "Negotiated Non-Compliance: A Case Study of Regulatory Failure", (1987) 9 *Law and Policy* 69. The VEPA was described by its Chairman as "stretched to the limit" in a press statement: *The Age* 6 July 1990 *at 7. For general description of VEPA's resource problems see Auditor General; above n142 at 50-80; Greenpeace above n58. Melbourne Water's dealings with Nufarm are documented in: The Age* 14 June 1990 at 4; 9 May 1990 at 3; 30 September 1991 at 4.

145 The National Companies and Securities Commission, under Henry Bosch regularly engaged in "commercial settlements", undertaking not to pursue a prosecution in exchange for payments "in lieu of a fine". This was justified on the basis that full-blown prosecutions are costly, and have only a modest chance of success.

146 Normally audit results must be disclosed to the regulatory agency, and in States with FOI laws, such laws would create the possibility of public access — subject to the numerous (especially trade secrets) exemptions, where the document was not already fully publicly available. Greenpeace made use of the *Freedom of Information Act* 1982 (Vic) in its campaign against Nufarm's environmental practices. *Freedom of Information Act* 1982 (Cth), 1982 (Vic), 1989 (NSW), 1989 (ACT), 1991 (SA).

147 Section 60 of the *Environment Protection Act* (Vic) prohibits the disclosure of information relating to "any manufacturing process" as well as trade secrets. However, we submit that sections of statutes providing trade secrets provisions must protect such information in a discriminating fashion, not in an all encompassing manner as is provided for in the *Freedom of Information Act* 1982 (Cth), s43. See Public Interest Advisory Centre, *Toxic Maze* (1992).

tered auditors of those activities with "particular environmental significance" — is representative of this form of mandatory audit.[148]

Similarly Sweden drafted a law providing that from 1991, about 6,000 industrial establishments must submit an annual environmental report to the authorities on the conditions of compliance with the existing regulations and make this available to the public. This report was to be checked by an independent auditor and was to provide the basis on which the authorities would organise their inspection program and implement a performance improvement program.

Both the 1991 EC proposal and the Swedish initiative would involve substantial costs to industry which very probably (given the blanket nature of the requirement) could not be justified in cost benefit terms. Arguably, it is for this reason that both the EC discussion paper and the Swedish Bill encountered such fierce opposition from industry, and have not been implemented.[149] Nor is such an approach likely to be viable in practical terms, given necessarily limited agency resources and the inability to vet or otherwise follow up the results of industry-wide audits.

At the other extreme, mandatory audits might be required only in the most exceptional circumstances, where almost all else has failed. This is close to the current situation in Victoria where, as yet, only one mandatory audit of an industrial facility has been conducted (Nufarm) and where, at least under the provisions of s31C of the *Environment Protection Act*, audit and publication of results is contemplated as a requirement of last resort, after the failure of an entity to devise and fulfil the requirements of an Environment Improvement Plan (EIP).[150] The Director of the EPA's audit team has indicated that the role of the team is not to carry out mandatory audits.[151] It remains to be seen whether Victoria will make more liberal use of environmental audit once the recently assembled audit team becomes fully operational.

If the use of audit is limited to exceptional circumstances, then audit can have little impact as a regulatory tool, and (once the extreme unlikelihood of being subjected to an audit is understood by industry) the agency has lost almost all the leverage which mandatory audit might provide.

Somewhere between these two extremes lies the possibility of "targeted" mandatory audit in appropriate specified circumstances. This would avoid the cost excesses, inappropriateness and impracticability of the "blanket" approach, and the lost opportunities involved in the "exceptional circumstances" approach. It would avoid imposing audit on (and thereby alienating) entities which are quite willing to undertake such action voluntarily (for example, for reasons of rational self-interest) and it would focus on those who are unwilling to undertake voluntary action despite a poor environmental performance

148 "Commission to Meet with Industry, Before Making Decision", *Int'l Environment Reporter*, 27 February 1991. The EC has subsequently opted for a voluntary incentive-based approach. Above n105.

149 "Commission Changes Tack on Environmental Auditing" (1991) *ENDS Report*, at 194.

150 Sections 31C(3), (4)(a).

151 Interview with Jeff Bazelmans employee of VEPA, 26 September 1992. Above n45.

(as measured by government inspections).[152] It would, in short, seek to maximise benefits and minimise costs.

Specifically, under such a policy, mandatory audit might be imposed:

- wherever greater management awareness of the environmental problems of the regulated enterprise would be likely to substantially reduce the likelihood of repeated non-compliance;[153]
- where there are reasonable grounds to suggest regular failure to comply with environmental obligations;[154]
- subsequent to discovery of a major breach(es) of environmental legislation as part of a negotiated settlement between the agency and regulated entity.

5. *Audit and Broader Regulatory Theory*

The main thrust of this article has been to specify in which ways and under what circumstances environmental audit can be used as a tool of regulatory strategy. This analysis can be usefully located within the broader theoretical literature on regulatory policy, particularly by reference to Ian Ayres and John Braithwaite's pathbreaking book, *Responsive Regulation*[155]. While an extended treatment of that work would not be appropriate, nevertheless some indication of the links between their broader analysis, and the more specific issues addressed in this article, will further demonstrate the considerable benefits and versatility of the audit mechanism as a tool of regulatory strategy.

In essence, Ayres and Braithwaite argue that the current debate about social regulation — framed in terms of an all or nothing choice between laissez-faire and "command and control" regulation — is limited and unproductive. They claim that far more can be achieved through exploring forms of regulation which involve a more creative interplay between state regulation and self-regulation by industry. Specifically, they propose:

> that certain regulatory tasks might be delegated to private parties but that this delegation be reinforced by traditional forms of regulatory fiat — if delegation fails. By delegating certain regulatory tasks to private parties, government can more closely harmonize regulatory goals with laissez-faire notions of market efficiency. The delegated aspects of responsive regulation hold out the prospect of a regulatory equilibrium that retains many of the important benefits of competition while the potential for escalating intervention maintains the integrity and pursuit of regulatory goals to correct market failure.[156]

Ayres and Braithwaite do not examine the role that environmental auditors might play in the delegation of regulatory tasks. Nevertheless, their general framework can be applied to environmental audit in ways that are in harmony

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152 For example, action might be confined to repeat offenders.

153 This means that some companies may be classified as "incompetent" rather than as rational maximisers of self-interest. See n157 below.

154 ESD Manufacturing Working Group, above n70 at 156, Recommendation 49.

155 Ayres, I and Braithwaite, J, *Responsive Regulation: Transcending the Deregulation Debate* (1992).

156 Id at 158.

with the arguments we have made in the preceding section. In terms of that framework, three strategies in particular can be used to achieve more effective and responsive regulation through the mechanism of environmental audit.

A. The enforcement pyramid

The enforcement pyramid is a strategy aimed at maximising the benefits and minimising the costs of government regulation, which operates on the premise that business is neither uniformly "good" (ethical and trustworthy) nor uniformly "bad" (untrustworthy and unwilling to comply with legal obligations). Braithwaite argues, with good reason, that most businesses may contain an element of both, and that which element prevails will vary with time and context.

Moreover, business will include not only rational economic actors, consciously calculating costs and benefits in pursuit of their self-interest, but also those who are "irrational" resisters to government authority (the Appalacian mine owner who chases the government inspector off his property with a gun), and those who are technically incompetent to comply with the spirit of the law (for example, most third world pharmaceutical manufacturers and most pre-FDA US manufacturers).

What then is a rational strategy for dealing with this mixture of good and bad, irrational and incompetent — particularly given that it is not easy to classify any given enterprise in advance?

Braithwaite's answer is to develop a regulatory enforcement pyramid:

> At the base of the pyramid, regulators assume and nurture virtue— corporate responsibility ... When virtue fails, regulatory strategy shifts through escalating deterrent responses. When deterrence fails, strategy shifts again to an incapacitative response. [157]

An environmental audit strategy could be structured so as to fit the enforcement pyramid as follows. Voluntary audit with voluntary disclosure of the audit results fits comfortably at the base of the pyramid. It is a low cost self-regulatory strategy which should be invoked as a first preference wherever industry demonstrates "virtue", that is, a commitment to environment protection goals (and a willingness to implement the spirit of the law). Incentive-based audit also fits close to the bottom — it assumes virtue — but that firms may need to be nudged in the right direction by being offered sufficient "carrots". Only if these strategies fail, should there be more interventionist escalation up the regulatory pyramid, to mandatory audit (in itself an expensive exercise to be used only where all else fails — but given the costs it imposes on industry, also an effective deterrent). Mandatory audit itself can of course be reinforced by various forms of more traditional regulatory fiat.

As Braithwaite points out:

> A paradox of the pyramid is that the signalled capacity to escalate regulatory response to the most drastic of measures channels most of the regulatory action to the cooperative base of the pyramid. The bigger the sticks at the disposal of the regulator, the more it is able to achieve results by speaking

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157 Braithwaite, J, "Responsive Business Regulatory Institutions" in Cody, C A J and Sampford, C J E (eds), *Business, Ethics and Law*, (1993), at 88.

> softly. When the consequence of firms being non-virtuous is escalation ultimately to corporate capital punishment, firms are given reason to cultivate virtue.[158]

Braithwaite's conclusion is that pyramidal forms of responsive regulation (in which audit can clearly play an important role) "hold out the possibility of nurturing the virtuous citizen, deterring the venal actor and incapacitating the irrational or dangerously incompetent actor".[159]

B. Tripartism: Delegation to Public Interest Groups

Ayres and Braithwaite define tripartism as

> a regulatory policy that fosters the participation of PIGS [Public Interest Groups] in the regulatory process in three ways. First, it grants the PIG and all its members access to all the information that is available to the regulator. Second, it gives the PIG a seat at the negotiating table with the firm and the agency when deals are done. Third, the policy grants the PIG the same standing to sue or prosecute under the regulatory statute as the regulator. Tripartism means both unlocking to PIGs the smoke-filled rooms where the real business of regulation is transacted and allowing the PIG to operate as a private attorney general.

In the environmental arena, where firms are often unwilling to implement regulation voluntarily and where regulatory agencies are frequently under-resourced and relatively ineffective, then public interest groups can clearly play an important role, and demonstratively already do so. Yet such groups are frequently hampered by a lack of information, without which their effective participation in tripartite initiatives is likely to be seriously prejudiced.[160]

Here also, audit can play an important role. For although there are some circumstances where the confidentiality of audit information may be paramount,[161] there are others where an environmental audit is a highly effective means of providing information about a company's environmental performance.

In particular, environmental audit as an aspect of community right to know legislation[162] and the mandatory disclosure of environmental liabilities under Corporations legislation,[163] examined above, are particularly potent ways of providing environmental groups with essential information. This will enable them to act as a countervailing force acting both to put pressure on business and to keep government regulators "on track".

C. Enforced self-regulation

In arguing in favour of enforced self-regulation, Ayres and Braithwaite seek to extend and individualise the more widely recognised strategy of co-regulation. Co-regulation usually means industry-association self-regulation with

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158 Ibid.
159 Id at 89.
160 Above n155 at 57, 58.
161 Above, n34.
162 Above, nn108-18.
163 Above, nn123-34.

some oversight and/or ratification by government,[164] perhaps strengthened by public interest group participation.

In contrast, Ayres and Braithwaite see enforced self regulation.

> ... as a form of subcontracting regulatory functions to private actors. In particular, enforced self-regulation envisions that in particular contexts it will be more efficacious for the regulated firms to take on some or all of the legislative, executive, and judicial regulatory functions. As self-regulating legislators, firms would devise their own regulatory rules; as self-regulating executives, firms would monitor themselves for noncompliance; and as self-regulating judges, firms would punish and correct episodes of noncompliance. We stress that which particular regulatory functions should be "subcontracted" to the regulated firms will be contingent on the industry's structure and historical performance. Delegation of legislative functions need not imply delegation of executive or adjudicative functions.[165]

Specifically, Ayres and Braithwaite are in favour not only of retaining public enforcement of privately promulgated standards, but also of invoking the enforcement pyramid described above, as a means of discouraging foot-dragging by firms that claim to be regulating themselves, but who use this as a guise to avoid their legal obligations.

In effect then, Ayres and Braithwaite are endorsing a "half-way house" of publicly blessed, but partly internal, modes of regulation as a means of encouraging more effective compliance. By so doing, they seek to avoid both the stultification of innovation, delay, and excessive costs commonly associated with direct government regulation, and the naivete of trusting companies to regulate themselves:[166]

> Under enforced self-regulation, the government would compel each company to write a set of rules tailored to the unique set of contingencies facing that firm. A regulatory agency would either approve these rules or send them back for revision if they were insufficiently stringent. At this stage in the process, PIGs would be encouraged to comment on the proposed rules. Rather than having governmental inspectors enforce the rules, most enforcement duties and costs would be internalized by the company, which would be required to establish its own independent inspectorial group.[167]

Thus enforced self-regulation largely involves subcontracting regulatory functions to private actors. In the environmental arena, it is apparent that the mechanism most appropriate to achieve "internal compliance" is again environmental audit, for reasons described in detail in previous sections, and that in-house third party environmental auditors are the actors most appropriate to perform the tasks of enforced self-regulation.

5. *Conclusion*

Existing government strategies for curbing environmental degradation have substantial limitations. In particular, traditional "command and control" regu-

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164 Above n155 at 102.
165 Above n155 at 103.
166 Id at 106.
167 Ibid.

lation relies heavily on the enforcement of standards through threat of sanctions (eg, withdrawal of licence, fines, liability for clean up and compensation costs). This approach often results in unnecessary adversariness and in regulations which are inflexible, excessively costly for industry to comply with and for agencies to apply. These problems are exacerbated by the serious inadequacy of regulatory resources and by a consequent inability to provide for effective monitoring and reporting of emissions and by small fines and the lack of deterrence effect of court actions. These limitations of traditional approaches suggest the need for broader and more innovative regulatory strategies.

Environmental audit is one such strategy. However, in Australia, the potential of audit as a regulatory mechanism has barely been tapped, and only voluntary audits are widespread. Victoria is tentatively experimenting with mandatory audit but no other jurisdiction has followed suit. Moreover, there has been very little debate, or understanding of the potential of other forms of audit explored in this article: incentive, information or subsidy-based audit, or audit prescribed under the Corporations Law.

This is unfortunate. Australia badly needs a more flexible, imaginative approach to regulation, in which a broad-based audit strategy could play an important role. As we have argued, no single form of audit can adequately facilitate such an approach. However, by invoking *different* types of audit it will be possible to influence effectively the behaviour of different types of regulated enterprise, whose response to environmental regulation may vary from willing compliance, through ignorance and incompetence, to strenuous resistance.

Each type of audit has different strengths, and is directed to a different context. The most crucial distinction is between pure voluntary audit (where the results commonly remain confidential to the audited entity) and incentive-based, mandatory and information-based strategies (where the results are accessible to regulators and also sometimes to the public).[168]

Voluntary audits have two principal benefits. First, they provide a reliable, flexible and efficient means of facilitating compliance and thereby enable firms and directors to avoid civil and criminal penalties, and to respond appropriately to new laws. Second, they are a valuable management tool, generating important information about an enterprise's environmental problems, providing a cost-effective means of responding to environmental hazards, of opening up cost-saving opportunities and of facilitating environmental management and control. Through such audits, firms can often achieve substantial long term cost savings. Such audits are likely to become even more important as fines for environmental offences increase and the personal liability of directors and officers is further extended, and as charges for waste disposal increase. They can also play an important role in "enforced self-regulation" as indicated in the previous section.

Incentive-based, mandatory and information-based schemes have other benefits. These schemes all ease the burden of government regulators by transferring many of their responsibilities onto the regulated enterprise or a

168 In the case of incentive-based schemes, it may only be a general summary that is publicly available. Above n102.

third party auditor. Crucially, they enable regulators to obtain a comprehensive, highly skilled analysis of an individual firm's environmental problems, at the regulated enterprise's expense. This is consistent with the "polluter pays" principle. It also conserves scarce regulatory resources, which can then be redeployed to better effect in areas where no alternative regulatory mechanisms exist.

Such audits also complement government regulation in a number of other ways. They provide a means of verifying compliance with government regulation; they provide the government with information about the environmental practices (and violations) of enterprises that would not otherwise be available; they provide better assurances of compliance from regulated entities; and they offer considerably more flexibility than direct regulations. Arguably, they also create a less adversarial relationship between business and the regulator than traditional "command and control" regulation, enabling firms to devote resources to remediation rather than to avoiding or defending prosecutions.

Moreover, information-based, mandatory and incentive-based audits each have their own individual advantages. For example, information-based schemes (for example, Community Right-to-Know) enable community groups and other Non-Governmental Organisations to act as a "countervailing force", scrutinising the activities of both industry and government regulators, bringing pressure to bear for improved environmental practices, and making both more accountable. Mandatory audit provides regulatory agencies with powerful leverage against recalcitrant organisations which refuse to comply voluntarily with their legal obligations; while incentive-based schemes induce firms to engage in investigative, preventative and corrective action in circumstances where they might otherwise not have done so.

None of this is to suggest that audit is a panacea. Like any other regulatory mechanism, it has limitations. Most seriously, these include difficulties in verifying the scope, quality and accuracy of independent audits; in preventing auditors being co-opted by regulated enterprises, and in the extent to which non-voluntary audits are dependent for their effectiveness on the resources and commitment of regulatory agencies themselves.[169] These limitations, while real, should not detract from the very considerable advantages of environmental audit as a complementary mechanism to direct regulation: one which can achieve compliance in circumstances where existing forms of regulation cannot penetrate, and which can focus the attention of individual enterprises, government and the public to the need for improved environmental performance and thereby achieve substantial results.

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169 These issues are the subject of a separate article, above n138.