The Evolution and New Directions in Environmental Auditing and Compliance Management

Ridgway M. Hall, Jr.

Environmental auditing started in the late 1970s in response to the wave of high-impact environmental legislation enacted by Congress during that decade. The Clean Air Act, Clean Water Act, Resource Conservation and Recovery Act, and other laws spawned complex federal and state regulatory requirements carrying civil penalties of up to $25,000 per day of violation plus criminal penalties and jail time for knowing noncompliance. Companies unable to keep track of a rapidly expanding regulatory landscape were hit with notices of violation, enforcement actions, and citizen suits. They needed a reliable process for identifying the applicable requirements and getting into compliance.

The answer for many was environmental auditing—the process of identifying all applicable legal requirements and related objectives for a facility or group of facilities, conducting an inspection or "audit" of a company's compliance with them, and identifying all noncompliance.

By the early 1980s forward-thinking companies had established internal environmental auditing or "assessment" groups, either as part of an environment, health, and safety (EH&S) program or as a separate entity reporting to senior management. The goal was to reduce potential liability and improve EH&S performance by establishing programs to identify all of a company's legal obligations and objectives and ensure ongoing compliance. These included regular auditing of the company's facilities, typically at three- or four-year intervals or more frequently as needed, based on risk-based prioritization. The need for objectivity and independence was quickly recognized so that audited plants or their organizational managers could not influence the auditors.

As programs developed it became clear that many facilities should have an "environmental coordinator," knowledgeable of the relevant regulatory requirements, with visible support from the plant manager, to ensure day-to-day compliance. Appropriate training and education of environmental coordinators and other plant personnel was critical to the compliance programs' success, as was support from the CEO and senior managers, because the programs competed for funds with the core functions of the businesses.

In the early years auditors would go out to a facility armed with the Code of Federal Regulations and the relevant state requirements. They requested relevant documents in advance, developed extensive checklists and questionnaires, and spent long days doing detailed facility inspections and record reviews, followed by nights in a motel room reviewing notes. Today auditing checklists typically are computerized. A number of software companies offer excellent products enabling the auditor to identify the relevant federal, state, and local requirements, quickly fashion a reliable checklist, and conduct the audit more efficiently.

After the audit, a good corrective-action plan included a review of frequently occurring and repeat violations as well as a "root cause" analysis so that the underlying conditions giving rise to noncompliance were addressed. These causes could include lack of education or training of the environmental coordinators or the plant personnel; equipment not performing properly or not being adequately maintained; failure to use proper sampling or monitoring procedures; or inadequate resources.

By the early 1990s companies were beginning to refer to their programs as "environmental management systems" or "EMSs." Often these programs included not only compliance auditing and corrective action, but training and education, product stewardship, waste minimization, and community outreach programs. Many included health and safety requirements under the Occupational Safety and Health Act.

The U.S. Environmental Protection Agency (EPA) recognized that environmental auditing programs led to heightened awareness and compliance with environmental requirements. On July 9, 1986, EPA published an Environmental Auditing Policy Statement, which, among other things, stated that it would take into account in the enforcement context a company's good-faith efforts to assure compliance through environmental auditing. 51 Fed. Reg. 25,004. Recognizing that confidentiality is important to candor in the internal reporting of violations, EPA stated that as a matter of policy it would not normally request copies of environmental audit reports in the exercise of its information-gathering authority. EPA set forth what it viewed as the basic elements of an effective auditing program: (1) explicit top-management support for environmental auditing and a commitment to follow up on audit findings; (2) an environmental auditing function independent of audited activities; (3) adequate auditor team staffing and training; (4) explicit audit program objectives, scope, resources, and frequency; (5) a process that collects, analyzes, interprets, and documents information sufficient to achieve audit objectives; (6) procedures to prepare candid and clear

Mr. Hall is a senior counsel in the Washington, D.C., office of Crowell & Moring LLP. He may be reached at rhall@crowell.com.

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written reports followed by corrective action; and (7) quality-assurance procedures to assure the accuracy and thoroughness of environmental audits.

These elements and the related policy were reexamined by EPA in 1994 and reaffirmed. 59 Fed. Reg. 38,455 (July 28, 1994). They remain in effect today.

The U.S. Department of Justice (DOJ) also has long had a policy of encouraging environmental auditing and recommending leniency in exercising its enforcement discretion where a company has an effective environmental auditing program in place. On July 1, 1991, DOJ issued a policy document entitled "Factors in Decisions on Criminal Prosecutions for Environmental Violations in the Context of Significant Voluntary Compliance or Disclosure Efforts by the Violator." The purpose was to encourage self-auditing, voluntary disclosure, and correction of violations by the regulated community. As an incentive, DOJ indicated that it would not bring criminal enforcement actions against violators with such programs.

The U.S. Department of Justice has long had a policy of encouraging environmental auditing and recommending leniency in exercising its enforcement discretion where a company has an effective environmental auditing program in place.

A similar policy is reflected in the draft "Corporate Sentencing Guidelines for Environmental Violations" dated November 16, 1993, which were developed by an Advisory Working Group on Environmental Offenses for the United States Sentencing Commission. The guidelines set forth mitigating factors to be considered in the sentencing context, including whether a company has in place an effective program to prevent and detect violations, incentives for compliance, and sanctions for noncompliance. They were never finalized but reflect the types of factors that DOJ and courts consider.

In designing environmental compliance programs, companies often include EPA, DOJ, and Sentencing Guidelines elements, at least to some extent. Then if an inspector finds violations, the company can benefit from being able to show that it had a well-designed program in place.

A distinct practice, closely related to compliance auditing, is the Environmental Site Assessment (ESA) in which an auditor inspects one or more facilities to determine if there is evidence of an environmental release of any hazardous substances or other pollutants, including any petroleum product. This is typically done in the context of a commercial transaction when a buyer is about to acquire the property or the company that owns the property. The ESA includes not only a physical site assessment but an interview of knowledgeable company employees, a search of the land records, and utilization of databases to determine whether there is evidence of any off-site release or shipment from the facility in question. The ESA is sometimes also referred to as a Phase 1 site assessment to distinguish it from a Phase 2, which involves gathering media samples.

The "gold standard" for conducting an ESA is the American Society for Testing Materials' (ASTM's) "Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process," E 1527-05 (Nov. 2005), initially developed in 1993. The Superfund Brownfield Amendments of 2002 provide a shield from Superfund liability for innocent landowners, bona fide prospective purchasers, and contiguous property owners, if prior to acquiring the land in question they conduct "all appropriate inquiry." *See* CERCLA §§ 101(35)(B)(i)–(iii), 42 U.S.C. § 9601(35)B)(i)–(iii). In 2005 EPA issued regulations at 40 C.F.R. pt. 312 setting forth the elements of "all appropriate inquiry." ASTM then amended its standards to include every element of the EPA regulations. In the business-acquisition context, it is often wise to do at least a limited regulatory compliance audit along with an ESA. This enables the acquiring company to identify any potential compliance problems, evaluate the costs of correction and possible penalties that may be associated in the event that they come to the attention of an enforcement agency, and take these matters into account in determining the purchase price and other terms of the purchase and sale agreement. In some cases, discovery of major environmental violations or contamination has either prevented the transaction from going forward or resulted in a significant reduction of the purchase price or restructuring of the payment schedule.

On December 22, 1995, EPA first issued a policy entitled "Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations," 60 Fed. Reg. 66,706, rev. 65 Fed. Reg. 19,618 (Apr. 11, 2000) (Audit Disclosure Policy) to encourage companies to engage in environmental auditing and take appropriate corrective and preventive measures. For entities that meet the conditions of the policy, EPA will waive or reduce gravity-based civil penalties, decline to recommend criminal prosecution, and refrain from routine requests for copies of the audit reports. EPA normally will not waive penalties for any "economic benefit" derived by the company from noncompliance as allowing a company to retain that benefit would run contrary to EPA's policy of not allowing violators to profit from noncompliance. However, particularly for violations that are severe or long occurring, waiver of the gravity-based component can result in very

substantial savings.

There are nine conditions a company must satisfy to gain the benefits of this policy. They emphasize voluntary discovery and prompt disclosure (within twenty-one days of discovery) and correction. As of December 2008, more than 5,000 companies had made voluntary disclosures to EPA and taken corrective action at approximately 14,650 facilities. Many others have made similar disclosures to state agencies.

In 2008 EPA amended its Audit Disclosure Policy to provide enhanced incentives for disclosure by companies that acquire facilities where preexisting violations are found. *See* "Interim Approach to Applying the Audit Policy To New Owners," 73 Fed. Reg. 44,991 (Aug. 1, 2008). The amendment allows the "new owner" to audit the property, either before or after the closing date and, within the nine months following closing, gain the benefits of the Audit Disclosure Policy either by (1) entering into an audit agreement with the agency and disclosing violations following the audit or, in the absence of an agreement, (2) disclosing violations within twenty-one days of discovery or forty-five days of the closing, whichever is later. New owners get a fresh start, avoiding liability for past violations.

Standards for Environmental Management Systems

In 1996 the International Organization for Standardization (ISO) published its ISO-14001 international standard for "Environmental Management Systems" (EMS) and a companion ISO-14004 document containing general guidelines on principles, systems, and supporting techniques for use in designing and implementing an EMS. These documents were revised in 2004 and have had a major impact on the design of environmental-management and compliance-assurance programs. Because the standards were adopted by an international standards-setting body with broad international representation, they will in all likelihood continue to be widely used for years to come. The basic elements required for an EMS under ISO-14001 are as follows:

1. *Environmental Policy*. A policy issued by top management that includes a "commitment to comply with applicable legal requirements and with other requirements to which the organization subscribes," a commitment to continual improvement and pollution prevention, and communication of the policy to all personnel and the public.

2. *Environmental "Aspects."* A scope that includes all activities that either impact the environment or are subject to environmental regulation.

3. *Identification of Legal and Other Requirements*. The program must identify everything with which the EMS is to ensure compliance.

4. *Objectives, Targets, and Programs*. Regularly set environmental objectives and targets and programs to achieve them.

5. *Resources, Roles, Responsibility, and Authority*. Assurance of resources to "establish, implement, maintain and improve" the EMS and clearly defined roles and responsibilities.

6. *Competence, Training, and Awareness*. Effective training and education for persons responsible for compliance or whose activities could cause environmental impacts.

7. *Communication*. Procedures for effective internal and external communications.

8. *Documentation*. Environmental policies, objectives and targets, and other main elements of the EMS must be documented.

9. *Document Control*. EMS documents must be kept current and available.

10. *Operational Control*. Operations must be consistent with the organization's environmental policies and requirements.

11. *Emergency Preparedness and Response*. Procedures must be in place to identify, prevent, mitigate, and respond to emergencies.

12. *Monitoring and Measurement*. Referring to operations that impact the environment.

13. *Compliance Evaluation*. Appropriate compliance evaluation (including auditing and less formal surveillance) must be conducted and appropriate records then must be maintained.

14. *Nonconformity, Corrective Action, and Preventive Action*. Procedures for identifying noncompliance and taking corrective and preventive actions must be established.

15. *Control of Records*. Maintenance of records to demonstrate conformity with the EMS, including a record-retention and disposal policy.

16. *Audits*. Objective, impartial, and regularly scheduled audits of the EMS to determine proper implementation and continued compliance must be conducted and management must be kept apprised of the audit results.

17. *Management Review*. Top management must review the organization's EMS and its performance at regular intervals (typically annually) to ensure its continuing adequacy and effectiveness.

Thousands of organizations around the globe have become ISO-14001 certified over the past twelve years.

EPA has expanded on the ISO-14001 standards to place greater focus on assuring compliance with all applicable environmental legal requirements. Under the leadership of Steven W. Sisk in EPA's National Enforcement Investigations Center in Denver, EPA has developed a Compliance-Focused Environmental Management System—Enforcement Agreement Guidance (EPA-330/9/97-002R, rev. June 2005) as part of OECA's policy to encourage all organizations to develop EMSs designed to ensure compliance. The EPA document includes model settlement agreement language for plea agreements and consent decrees. EMS requirements based on this guidance have been incorporated in numerous settlement agreements with EPA and other agencies. *See* John Peter Suarez, EPA OECA, Guidance on the Use of Environmental Management Systems in Enforcement Settlements as Injunctive Relief and Supplemental Environmental Projects (June 12, 2003); EPA, Position Statement on Environmental Management Systems (EMSs), 71 Fed. Reg. 5664 (Feb. 2, 2006) (supporting the use of EMSs), and EPA materials at www.epa.gov/ems/policy/position.htm.

Some organizations are combining the ISO-14001 standards with other programs to provide "one-stop" compliance shopping. In 2002 the American Chemistry Council combined its Responsible Care Program, initially developed in 1988 to provide proactive EH&S management and product-stewardship codes for its member companies, with ISO-14001 to produce "RC14001" to enable a member company that wants ISO-14001 certification as well as Responsible Care compliance verification to adopt a single hybrid program. This program is then audited, and the company receives a certificate of compliance with both programs.

For multinational corporations, the emergence of ISO-14001 has provided a framework for compliance-assurance programs with global credibility. Meanwhile, the ISO has proceeded to set standards for a variety of other environmentally related activities, such as auditor training, eco-labeling, life-cycle assessments, and greenhouse gas (GHG) reduction programs (discussed below). Environmental engineering and law firms have established offices in numerous countries throughout the world to provide support. For an excellent compendium of practical guidance on the design and implementation of EMSs, see Frank Friedman's *Practical Guide to Environmental Management* (Environmental Law Institute, 10th ed. 2006).

Auditable Sustainability and Corporate Social Responsibility Programs

For over a decade companies have been developing programs designed to reflect concepts of "sustainable development" and corporate social responsibility (CSR), but only recently have techniques evolved for auditing the effectiveness of these programs, driven in part by corporate recognition that numerous stakeholders, including employees, neighbors, and investors, have pressured companies to "go green" to help save the planet. In *Green to Gold: How Smart Companies Use Environmental Strategy to Innovate, Create Value, and Build Competitive Advantage* (Yale University Press 2006), Daniel Esty and Andrew Winston provide case studies in which companies adopted programs to reduce waste generation, energy costs, and the use of toxic raw materials and to "green" their supply chain to enhance product appeal. In doing so, the companies increased market share and profits.

Efforts to encourage environmentally responsible behavior beyond compliance have been encouraged by nongovernmental organizations (NGOs). In 1992 the Coalition for Environmentally Responsible Economies (CERES) published the "CERES Principles," which call on companies to adopt programs specifically designed to reduce pollutant releases, make sustainable use of renewable natural resources, conserve energy, reduce risk, make product safety a priority, and clean up any environmental damage caused by their operations. The CERES Principles call for annual self-evaluations and public reporting of the results. Dozens of companies signed up, and many began publishing annual reports touting their accomplishments.

The Global Environment Management Initiative has published guidance on "total quality environmental management." The Global Reporting Initiative has published "Sustainability Reporting Guidelines." The World Bank published a comprehensive set of "Environmental Standards" in July 1998 to guide the conduct of recipients of financial assistance. The guidelines, which are periodically updated, extensively address sustainable development, natural-resource protection, and pollution prevention. A number of banks in the private sector have developed the "Equator Principles" along similar lines.

As companies respond to stakeholder demands for meaningful sustainability and CSR programs, managers are recognizing that it is difficult to manage what is not measured. Early claims of environmental achievements that could not be substantiated were decried as "greenwash." The Federal Trade Commission has adopted regulations designed to curb such claims. *See Guides for the Use of Environmental Marketing Claims* (Green Guides) at 16 C.F.R. pt. 260. In response, companies and NGOs have begun developing performance standards and benchmarks to document claims of pollution reduction, reduction in the use of toxic raw materials, biodegradability of products following disposal, and percentage of energy from renewable sources. ISO is well advanced in developing a "Guidance on Social Responsibility," ISO-26000, scheduled for issuance in fall 2010. Early drafts of these standards have focused on human rights, fair labor practices, consumer protection, responsible operating practices, and community involvement, as well as EH&S protection.

The result has been that the field of environmental auditing is now expanding to include checklists designed to measure achievement of sustainability and CSR goals. While reductions in environmental releases for the use of toxic raw materials can be fairly easily measured at a specific facility (TRI reports are one tool), the process gets complicated on a corporate-wide basis where there are purchases and sales of facilities, product-line changes, and fluctuations in production unrelated to environmental goals. In addition, use of environmentally friendly raw materials and packaging involves assessing product and material performance claims that may not have been demonstrated over a sufficiently long period of time for the results to be fully reliable.

In a 2007 Grant Thornton survey of 510 U.S. business executives, 77 percent of the executives predicted that CSR programs will have a "major impact" on business strategies over the next few years, and nearly the same number believe such programs can enhance companies' profitability. Ecosystem and biodiversity protection are also increasingly a focus of companies whose operations have the potential to disrupt or damage the environment. Auditing such diverse programs must include at minimum determining whether or not a company is doing what it claims to be doing.

As efforts to address global warming and climate change have proceeded, companies are increasingly developing GHG-reduction programs that embody specific numerical goals. In countries implementing the Kyoto Protocol, these programs

are mandatory. Apart from those, some states and regions in the United States have adopted climate-protection programs, which have led to companies examining their carbon footprint and looking for ways to reduce their GHG emissions. In response, ISO published a "Standard for Climate Change," ISO-14064 (2006), which includes procedures to quantify and report GHG emissions and removals, including measures to ensure that the removals are quantifiable, reasonably permanent, and in addition to what would otherwise be legally required. A companion ISO-14065 sets forth procedures for verification bodies to use in accrediting GHG auditors. A widely used guideline for implementing ISO-14064 is a GHG protocol designed by the World Resources Institute and the World Business Council for Sustainable Development to assist organizations and governments in identifying, quantifying, and registering GHG-reduction amounts, or "offsets." *See* "The Greenhouse Gas Protocol: A Corporate Accounting and Reporting Standard" (rev. ed. Mar. 2004), *available at* www.ghgprotocol.org/files/ghg-protocol-revised.pdf.

The ISO-14064 standards are now being used by The Climate Registry, whose membership includes entities across the United States and Canada, as a foundation for their programs. The carbon-emission offset trading programs run by the Chicago Climate Exchange and the Canadian GHG Offset Program are also based on ISO-14064. Meanwhile, ISO is developing a new companion standard, ISO-14066, to define competence requirements for GHG validators and verifiers.

Auditing for compliance with GHG protocols and standards requires an entirely different skill set than that of environmental compliance and EMS auditors traditionally. The audit team must include people with skills to measure direct and fugitive emissions of GHGs from traditional and nontraditional sources, such as trucks and automobiles, evaporation ponds, supply-chain sources, and customer use. The demand for these skills is already running high.

Where Are We Heading?

Over the next few years we are likely to see continued expansion and implementation of sustainability and CSR management and auditing programs. There will be an enormous expansion of GHG-reduction programs and auditing as nations move more aggressively to address climate change with legislation and regulations. We will see the continued internationalization of auditing programs. This will include programs to address regulatory initiatives, which themselves have international impacts, such as the European Union's Registration, Evaluation and Authorization of Chemicals (REACH) and Restrictions on Hazardous Substances (RoHS) regulatory programs.

Any business manager who has read Thomas Friedman's *Hot, Flat and Crowded* (2008) or Gus Speth's *The Bridge at the Edge of the World* (2008), which document in detail the fact that we humans are outstripping the capacity of the planet to sustain our current and projected living habits, is aware that integrating sustainability and social-responsibility programs into business planning and operations is not just a moral imperative or "trendy" but rather an economic necessity for long-term survival. Given the pressures to reduce energy consumption and use "clean energy" from renewable domestic resources, programs to achieve these goals will have priority as well.

Because of the increasing needs of corporate managers to ensure the reliability of auditing programs and audit results, there will be a greater effort to ensure auditor proficiency and qualifications. This will likely result in increased demand that individual auditors and program design satisfy at least minimum standards that are regarded as sound in the profession, such as those recently published by the Board of Environmental, Health and Safety Auditing Certifications (BEAC) discussed below.

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The increasing demand by corporate managers and other stakeholders for a high degree of accuracy and reliability of EH&S auditors' reports got a shot of adrenalin from the Sarbanes-Oxley Amendments (SOX) of 2002. SOX Section 302(a) requires that the "principal executive officer or officers and the principal financial officer or officers . . . certify in each annual or quarterly report" that, based on the officer's knowledge, the report does not contain any untrue statement of material fact or omit any material facts, that the signing officers have designed and maintained *internal controls* to ensure that material information relating to the company is made known to them, and that they have evaluated the effectiveness of those controls and made any appropriate changes. These requirements have made it absolutely critical that the auditing programs that are part of those "internal controls" be complete, accurate, and reliable.

Long before SOX, the SEC had regulations requiring disclosure of material environmental liabilities and expenditures. *See* 17 C.F.R. § 229.101 requiring, among other things, disclosure of estimated capital expenditures for environmental controls for the current and succeeding fiscal years, and § 229.103 requiring disclosure of "material pending legal proceedings," including any proceedings where a governmental authority is a

party and the proceeding involves potential monetary sanctions of $100,000 or more. In addition, § 229.303 requires that the Management Discussion & Analysis (MD&A) discuss business trends or events likely to have a material effect on the company's financial condition. The SEC staff and the Financial Accounting Standards Board have issued numerous guidance documents interpreting and amplifying on these requirements.

Although many companies today do not insist on adherence by their auditors and program managers to the BEAC Standards, insistence will likely occur with increasing frequency.

In addition, *In Re: Caremark International, Inc. Derivative Litigation*, 698 A.2d 959, 970 (Del. Ch. 1996), held that a company must have in place an information and reporting system that provides "timely, accurate information sufficient to allow management and the board . . . to reach informed judgments concerning both the corporation's compliance with the law and its business performance." Topics that must be the subject of the information flow include "corporate compliance with external legal requirements, including environmental, financial, employee and product safety, as well as assorted other health and safety regulations." *Id.* at 969. Failure to have such a program can not only result in significant liability to the company but can subject its directors to individual liability. Companies are already giving considerable weight to SOX, *Caremark*, and SEC reporting requirements in designing their audit programs. That trend will continue.

With respect to auditor qualifications, the most recent and comprehensive addition to the landscape is the BEAC *Performance and Program Standards for the Professional Practice of Environmental, Health and Safety Auditing*, published in December 2008. BEAC was formed in 1997 as a joint venture of the [EH&S] Auditing Roundtable and the Institute of Internal Auditors to provide certification programs for the professional practice of environmental auditing. The standards are organized into four sections, addressing the subjects of auditor and audit program independence, due professional care in the conduct of audits, the performance of audit work, and the design and implementation of audit programs. The text of the standards is relatively brief and concise, and the standards are mandatory for those who wish to represent that their audit or program conforms to the BEAC Standards. They are accompanied by more detailed guidance that provides practical commentary and tips on how to achieve compliance.

With respect to independence, the purpose of the standards is to ensure that auditors are objective and independent of the activities that they audit and free from any conflict of interest. Similarly, an internal audit program should be independent of the business units audited and should report directly to senior management. The provisions on "due professional care" address professional competency, i.e., making sure that auditors possess the relevant knowledge, skills, and experience, including appropriate training and education, so that their performance will result in an audit that is accurate, complete, and reliable.

The provisions regarding performance of the audit essentially codify what has been widely regarded as sound practice within the EH&S auditing profession. This includes the adoption of plans and procedures to ensure the gathering and review of all appropriate information from all relevant sources, best efforts to ensure its reliability, and a written report. To a large extent, the program standards embody elements described above in the discussion of EPA's 1986 auditing program elements and the ISO 14001 EMS standards. However, they go further in describing the important relationships and responsibilities of the audit program director, senior management, and the board of directors so as to ensure that the audit program is designed and implemented consistently with the organization's policies, objectives, and goals and includes measures to ensure the proper planning and scheduling of audits, appropriate auditor qualifications, corrective and response action following the audits, and periodic review of the program at senior levels to ensure that it is operating properly. The *Caremark* requirement for the timely flow of important EH&S information to senior management and the board is also reflected.

Although many companies today do not insist on adherence by their auditors and program managers to the BEAC Standards, insistence will likely occur with increasing frequency because of the increasing pressures reflected in SOX and stakeholder demands for accurate and reliable information. In addition, auditors are increasingly looking for guidance in avoiding potential professional liability if they are accused of missing or incorrectly describing a noncompliant condition, leading to potentially substantial exposure. Compliance with the BEAC auditing standards should provide a defense to such claims.

The practice of environmental auditing and the design of compliance-management programs are in a state of continuing evolution. With globalization presenting increasing demands for compliance assurance with a broadening set of regulatory requirements and policy objectives, program design is evolving more rapidly than ever. Sustainability and CSR programs, as well as GHG-monitoring and reduction programs, head the list of the areas where we can expect major new developments in the coming years. Exciting challenges and opportunities lie ahead for auditors, program designers, and business managers.