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# Implications of Financial Audit in Ensuring the Credibility of Greenhouse Gas Emissions Statements

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## Abstract

*The sustainable development of national and international markets highlights the link between the emissions of greenhouse gases and climate change, a problem that cannot be overlooked during the development of financial audit as a profession, implicitly by the financial auditor's spectrum of activities. Knowing the role of the financial auditor in providing reasonable or limited assurance on environmental issues, by developing an understanding of the circumstances and specificity of such financial audit engagement opens up a research niche that seeks to answer several questions such as: how the impact of greenhouse gas emissions on the environment can be credibly measured/evaluated? Is it necessary in the assurance engagement for the financial auditors to use the activity of other practitioners/experts? How useful is the result of such an assurance service, within the national and European context? The authors consider that the answers highlight the role of the assurance services in affirming the credibility of the statements regarding greenhouse gases emission. The study addresses issues concerning the assurance engagement on non-financial statements regarding greenhouse gases in the specific situation in Romania, evaluating the perception of the respondents – financial auditors and representatives from the academic environment – on the opportunity of developing the financial audit services market, as well as identifying the need for development and improvement of the legislative framework in connection with the involvement of financial auditors in such assurance engagements.*

**Keywords:** financial audit; assurance engagements; ISAE 3410; greenhouse gases; environmental policy, interdisciplinary teams

**JEL Classification:** M41, M42, M48

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## 1. Introduction

Located in an interdisciplinary field, the assurance engagement on the statements regarding the greenhouse gases (GHG) offers the opportunity to develop the financial audit services market in Romania.

Within the context of the assurance engagements in the group 3000 – *Assurance Engagements, Other than Audits or Revisions of Historical Financial Information*, we find the existence of an international assurance standard with an "exotic" name, namely the standard ISAE 3410 -*Assurance on a Greenhouse Gas Statement*<sup>1</sup>. This standard was issued in 2011 with applicability from September 30, 2013. The object of the standard is the assurance engagement regarding the non-financial statement of an entity related to the GHG. Due to the link between the emission of these gases and climate change, GHG are of particular importance. The adequacy of these assurance engagements derives from (1) the existence of a regulated information submission regime, (2) as part of an emissions trading scheme, or (3) for investors or other parties information purposes, voluntarily. (ISAE 3410, pt. 1). However, the opportunity can be achieved in the existing context of a specific market for professional audit services, consisting of asserting the demand and the offer of professional services. *The demand for assurance services* is mainly influenced by the global requirement on entities to present their greenhouse gas emissions, as an effect of government policy addressing the global issue of climate change. *The assurance services offer* is influenced by the technical ability of the financial auditors to carry out this kind of specific engagement in collaboration with the technical specialists in the audited field. In the context of a specific market existence, for such professional audit services that channel the activity of financial auditors in the direction of a global theme, it is necessary to clarify some aspects related to climate change issues.

<sup>1</sup> IFAC (2015). Handbook of International Quality Control, Auditing, Review, Other Assurance and Related Services Pronouncements. Edition 2015. Volume II. Bucharest. 2016. CAFR Publishing House, ISAE 3410 – *Assurance engagements regarding greenhouse gases statements*, pp.238-327.

## 2. Literature review

The benefits of an independent assurance engagement on GHG emissions reporting were identified by PricewaterhouseCoopers (2007), but also by Simnett et al. (2009). As part of the formal development process of ISAE 3410, a preliminary study was conducted (Consultation Paper) in October 2009 (IFAC, 2009). This study highlighted problems focused on different aspects such as the engagement partner's problem; of the audit team involved in carrying out the assurance engagement; the usage of IAASB standards by users other than financial audit practitioners. Compared to a financial audit engagement of the financial statements, the assurance engagements related to GHG emissions statements would require the participation of specialists/experts outside the accounting profession, in particular chemical engineers or specialists in environmental issues (Nugent, 2008). The moment of introducing the trading of GHG emissions certificates is the starting point, where the cost of environmental degradation for society from this point of view is calculated into the cost of products, to reduce the costs of pollution (Samuelson, 2010). Economics theory points out that when the marginal cost of reducing GHG emissions is equalized across all industries, as well as globally, it can be guaranteed that environmental goals are achieved at the lowest costs (Samuelson, 2010, p. 163). This economic paradigm implies that efforts in this direction must be generalized, in all fields of activity and all geographical areas. The study conducted by the *Stern Review on the economics of climate change* highlighted that climate change is also influenced by the lack of financial information regarding the implicit costs related to environmental degradation, as well as the inability to include them in the cost calculation (HM Treasury, 2011). The topic of financial information regarding environmental issues, as well as the need to verify the degree of confidence provided by this information, was the topic of a research article (Hong L.C., 2014).

The article highlights the symbiosis between accounting and financial audit on these issues. Also, they foreshadow the perspective of the involvement of the accounting environment in the elaboration of accounting standards related to the environmental subjects. The issue of GHG assurance engagements and the attempt to answer the fundamental question of the legitimacy of such an approach where financial auditors could be

involved was the concern of Huggins et al. (2011). Another author (Green, 2009) addressed the need to supplement the professional experience of financial auditors who can provide assurance engagements related to GHG emissions, with the technical experience of other professional categories (engineers, environmental specialists) that are currently involved in this activity.

### 3. Research methodology

The research approach was based primarily on a qualitative analysis of the legal and economic

environment in Romania. Within this qualitative analysis, we evaluated the level of development of the corporate reporting system regarding social responsibility, but also on the existence of a trading market for GHG certificates. Also, we undertook an analysis of the specialized works that deal with this topic, in countries with experience in the field, to identify the level of conceptual and scientific development of the analyzed issue.

Secondly, for a quantitative approach, we asked a target group – made up of practitioners with experience in the field of financial audit and specialists in the academic field – a set of questions in the form of a questionnaire (Table no. 1).

Table no. 1. Methodological approach		
No.	Specific objectives	Questions asked by questionnaire
Q1	<b>Attitude towards risk</b> Understanding how the respondents want to position themselves in terms of the risk of the engagement, in its circumstances, as a basis for its conclusion.	In the context of the specific circumstances of an engagement applying ISAE 3410 <i>Assurance Engagements on Greenhouse Gas Statements</i> , do you think that a reasonable assurance engagement would be more appropriate than a limited assurance engagement?
Q2	<b>The need for collaboration with other experts</b> Assessing the degree of confidence in one's own professional experience necessary to make decisions regarding the measures appropriate to the circumstances of the engagement.	If you were involved in an ISAE 3410 specific assurance engagement, would you rely solely on your professional judgment or would you also use the services of other specialists?
Q3	<b>Social responsibility</b> Obtaining direct feedback from practitioners regarding their willingness to get involved in issues related to social responsibility, and the credibility of non-financial statements.	Do you consider that it would be useful to involve the financial auditors in auditing the non-financial statements issued by the entities, in the context of increasing the level of social responsibility?
Q4	<b>Attitude towards the quality of non-financial information</b> Knowledge of the respondents' perception regarding the impact on the quality of the statements regarding the greenhouse gases emission as a result of carrying out the assurance engagements according to ISAE 3410.	Will the involvement of financial auditors in assurance engagements by following ISAE 3410 increase the quality of statements regarding greenhouse gases?
Q5	<b>The financial perspective of assurance engagements</b> Identify the perception of the practitioners regarding their activity to the financial mechanisms of the services market in which they operate.	Do you consider that the value offered for an engagement accomplished by following ISAE 3410 could be higher than the price for an assurance engagement that would have a financial-accounting subject?
Q6	<b>Involvement in environmental issues</b> Assessment of respondents' confidence in climate change issues.	Do you consider that the impact of GHG emissions on climate change is a real effect?

Source: Author's projection

For the asked questions we used a dichotomous scale of answers, respectively the respondents had two options (affirmative and negative). In certain situations, the respondents presented answers with

certain clarifications or declared themselves undecided. These answers/responses were appreciated by the point of view of the conducted research. The questions were sent online, being

addressed to a group of 50 respondents, of whom 70% are financial auditors and 30% specialists from the academic field. The response rate to the questionnaire was about 66% (33 respondents), being relatively high, which concludes that the test results are valid, based on the use of the questionnaire. For the point of view of the geographical location of the respondents, we can say that they are relatively homogeneous, respectively about 40% are located in central and western Romania, 35% in the south of the country, and 25% are active in the east of the country. The level of interest of the respondents was high, which shows the increased interest that the subject of climate change incites on the collective mind.

We have statistically processed the answers received, to obtain an image on the impact that the application of the ISAE 3410 standard has on the financial auditors in Romania.

## 4. Results and discussions

### 4.1. National framework for accounting reporting

The national accounting referential OMFP 1802/2014<sup>1</sup> states that entities that, at the date of preparing the financial statements, exceed the average number of 500 employees during the reporting period must include a non-financial statement in the directors' report, a statement that contains, among other things, significant information on environmental issues, or social nature (OMFP 1802/2014, art. 492<sup>1</sup>). Among the environmental issues that need to be approached is information on GHG emissions, as well as the consequences of climate change that the activity of the entity influences. The non-financial statement must be evaluated by the statutory auditor, in terms of its provision, under legal conditions. The activity of the statutory auditor is minimal and is summarized for the point of view of the legal requirement only for identifying the provision of the specified information. We consider that a legislative extension of the requirements addressed to the statutory auditor in the

<sup>1</sup> OMFP no. 1802/2014 regarding the individual annual financial statements and the consolidated annual financial statements, *Official Gazette no. 963 of December 30, 2014.*

context of the application of ISAE 3410 is required. However, with the appearance of OMFP 3456/2018<sup>2</sup>, the requirement was extended to all entities that meet this criterion of the average number of staff over 500 employees during the reporting period. The increase of the reporting area for the companies that have to make this non-financial statement has a positive effect in the field of improving the information transparency regarding sustainability and social responsibility. Similar requirements are provided for the parent entities of a group (consolidated non-financial statement), if the same size criterion of the average number of personnel, individually or consolidated, is exceeded. These provisions are specific to corporate governance, representing a partial transposition of Directive 2013/34/EU as well as of Directive 2014/95/EU to ensure a regulated information disclosure regime, but at the same time it is a prerequisite for applying ISAE 3410.

### 4.2. The European framework for accounting reporting

Directive 2014/95/EU amending Directive 2013/34/EU regarding the reporting of non-financial and diversity information by certain entities or groups of entities refers to the obligation to report by large public-interest entities with more than 500 employees during the financial year, within the management report, a minimum of information regarding the environment, or some social aspects. Environmental issues should include significant details on the issue of GHG emissions, and similarly, statutory auditors should assess whether entities have provided the required information in non-financial statements. The involvement of statutory auditors is minimal, having the role of identifying the presentation by entities of a non-financial statement that must include certain information required by the corporate governance mechanism.

### 4.3. The Corporate Governance Code of the Bucharest Stock Exchange (BVB)

The corporate governance code of the BVB, mentions that within the corporate responsibility of a corporation, the entities traded on the regulated market of the BVB, will express, among other concerns of economic, social

<sup>2</sup> OMFP no. 3456/2018 regarding the modification and completion of some accounting regulations, *Official Gazette no. 942 of November 7, 2018.*

and environmental nature, they will prepare and disseminate periodic information according to the International Standards of Accounting Reporting (IFRS<sup>1</sup>), of a financial and non-financial nature. In this context, entities have the opportunity to report information on environmental issues, voluntarily, even if they do not meet the mandatory condition of the number of personnel required by law. The premise is created for the fulfilment of another condition of a possible application of ISAE 3410, namely, to inform investors or other parties, voluntarily.

#### 4.4. Global Reporting Initiative (1997)

A useful tool in the reporting of entities is the *GRI 305: Emissions 2016 Standard*, realized by the Global Reporting Initiative. This standard presents the reporting issues related to GHG, for the point of view of the management reporting approach. The standards issued by the Global Reporting Initiative represent a global approach to reporting sustainable development.

#### 4.5. Trading scheme for GHG emissions certificates

Within the framework of the national legislation in Romania, the United Nations Framework Convention on Climate Change (U.N.F.C.C.C.) was transposed by *Law no. 24/1994 for the ratification of the United Nations Framework Convention on Climate Change*<sup>1</sup>, but also the Kyoto Protocol by *Law no. 3/2001 for the ratification of the Kyoto Protocol to the United Nations Framework Convention on Climate Change*<sup>2</sup>. In this context in Romania, it is traded under the provisions of GD 780/2006<sup>3</sup>, EUA, CER and ERU certificates. These regulations were subsequently supplemented, the legislative and economic situation in Romania is in line with the European situation (Directive 2003/87/EC<sup>4</sup>) but

<sup>1</sup> Law no. 24 of May 6, 1994 for the ratification of the United Nations Framework Convention on Climate Change, signed in Rio de Janeiro on June 5, 1992, *Official Gazette no. 119 of May 12, 1994*.

<sup>2</sup> Law no. 3 of February 2, 2001 for the ratification of the Kyoto Protocol to the United Nations Framework Convention on Climate Change, adopted on December 11, 1997, *Official Gazette no. 81 of February 16, 2001*.

<sup>3</sup> GD 780/2006 regarding the establishment of the scheme for marketing the greenhouse gas emission certificates, *Official Gazette no. 554 of June 27, 2006*.

<sup>4</sup> Directive 2003/87/EC establishing a system for trading greenhouse gas emissions within the EU, *JO L 275, 25.10.2003, p. 32*.

also global. Within the European Union, the most recent changes were agreed in March 2018. In this context, we consider that the premise of the existence of a trading scheme for emission certificates is also fulfilled, to create the possibility of involving the financial auditors in the assurance activity presented by ISAE 3410.

#### 4.6. Use of the activity of other practitioners

The ISAE 3410 standard presents the need for the scientific and technical expertise necessary to carry out such an assurance engagement (ISAE 3410, point A19). In the specialized literature, we identify the opinion of W. Green (2009) who mentioned that the professional experience of financial auditors who can provide assurance engagements related to GHG emissions must be supplemented with the technical experience of other professional categories (engineers, specialists) that are currently involved in this activity.

#### 4.7. Analysis of databases in assurance engagements (ISAE 3410)

In the assurance engagement that constitutes the topic of ISAE 3410, the financial auditor can use the full range of available procedures, from the analysis of the implemented controls, confirmations, observation, analysis of estimates, use of sampling, but also analytical procedures. The results of environmental policies may be jeopardized if the data on which they are based is deliberately manipulated (Matthew et al., 2019). In the specialized literature, the problem of this deliberate manipulation of information concerning climate change is not widely identified. The application of analytical procedures can offer a solution to identifying such situations. One possibility to simplify the identification of data handling situations is provided by the application of Benford's Law based analysis (Matthew et al., 2019). This kind of application of a statistical type method, in analyzing the data derived from GHG emissions reporting, creates the possibility of rapid filtering of the technical information for which a financial auditor does not have a specific technical experience.

#### 4.8. Statistical results of the survey based on the questionnaire

Following the processing and analysis of the answers received from the respondents to the specific objectives investigated through the six questions, we obtained the numerical percentage results presented in **Table no. 2**.

**Table no. 2. Results obtained from the questionnaire questions**

Answer	Q1 (%)	Q2 (%)	Q3 (%)	Q4 (%)	Q5 (%)	Q6 (%)
Yes	69.70	39.39	81.82	78.79	57.58	84.85
No	18.18	54.55	15.15	12.12	27.27	9.09
Undecided	12.12	6.06	3.03	9.09	15.15	6.06
<b>Total</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>

Source: Author's work, 2020

We assigned to the affirmative answers (Yes) a truth value equal to 1, to a negative answer (No) the value 0, and to the undecided answers an intermediate value equal to 0.5. In this context, we calculated the average of the answers, the dispersion and the average square

deviation, for each question, the result of this statistical processing being presented in **Table no. 3**. We notice that the average square deviation is relatively high compared to the calculated average, the explanation being provided by the small sample size (50 items)

**Table no. 3. Statistical image of respondents' perceptions**

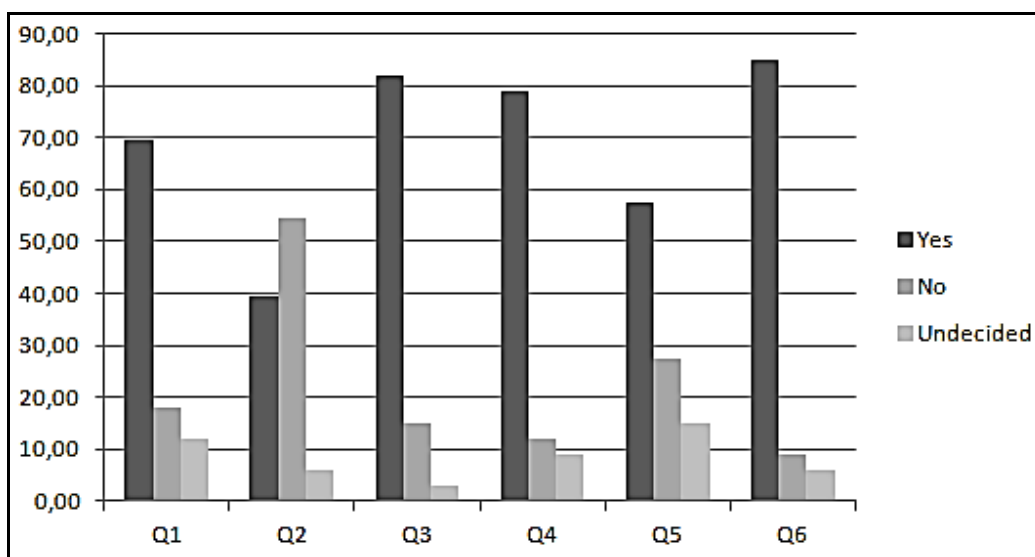
Answer	Q1	Q2	Q3	Q4	Q5	Q6
Average	0.76	0.42	0.86	0.83	0.65	0.88
Dispersion	0.15	0.23	0.13	0.12	0.19	0.09
Average square deviation	0.39	0.48	0.36	0.34	0.43	0.30

Source: Author's work, 2020

The numerical information obtained from the processing of the answers received from the questionnaire questions is represented graphically, in the form of histograms, in **Figure no. 1**. From the graphical

representation, it is observed intuitively, that in all the questions we obtained undecided answers in a small proportion and that the proportion of negative majority answers appears only for the second question (Q2).

**Figure no. 1. Histogram of respondents' perceptions**



Source: Author's work, 2020

*Q1: In the context of the specific circumstances of an engagement applying ISAE 3410 Assurance Engagements on GHG Declarations, do you think a reasonable assurance engagement would be more appropriate than a limited assurance engagement?*

To this question, approximately 69% of the respondents perceived the opportunity to carry out a reasonable assurance engagement, in the context of carrying out a specific engagement according to ISAE 3410. According to the definition presented in the ISAE 3000 Assurance engagements, other than audits or information reviews. financial historians, within a reasonable assurance engagement, the practitioner reduces the risk of the engagement to an acceptably low level, in the circumstances of the engagement, as a basis for its conclusion. The same standard details the definition of the limited assurance engagement, noting that "the practitioner reduces the risk of the engagement, but this risk is greater than in the case of a reasonable assurance engagement." From this point of view, the response option of the majority of the respondents expresses the wish to provide an engagement under the conditions of lower audit risk, but in the context of the possibility of obtaining adequate and sufficient audit evidence to substantiate the financial auditor's conclusion.

Out of the total number of respondents, a proportion of over 10% declared themselves undecided in choosing a variant of the type of engagement. For the point of view of the answers received, we can understand that the respondents prefer to carry out this type of assurance engagement, with a prudent attitude/approach, to minimize the risk of the engagement, as a basis for the conclusion. The nuanced answers received have drawn attention to the fact that the choice of the type of engagement must be correlated with the targeted users of the assurance report, with its destination and use, with the requirements and the wishes of the potential customer of the assurance service.

*Q2: If you were involved in an ISAE 3410 specific assurance engagement, would you rely solely on your professional judgment or would you also use the services of other specialists?*

In the context of accomplishing this type of engagement with technical/specialized aspects, the respondents in

proportion more than 50% opt for calling outside the use of their professional reasoning, and to the services of other specialists. The proportion of those based on their professional judgment is high, which is an indication of the maturation of the professionals in Romania. The respondents pointed out that professional reasoning is necessary to approach the option of using other specialists, within the context in which their own professional judgment itself is definitive in making decisions regarding the approach to the engagement. We can understand from the answers that the respondents want to take responsibility for the decision in carrying out this type of assurance engagement.

*Q3: Do you consider that it would be useful to involve financial auditors in auditing the non-financial statements issued by the entities that issue these statements, in the context of increasing the level of social responsibility?*

The respondents, in a majority proportion, over 80% trust that the participation of financial auditors in the audit of non-financial statements has utility that can influence the increase of the level of social responsibility. Some respondents appreciated the involvement of the financial auditors in this type of engagement, as having a useful utility in the context of the organizational culture, but at the same time not be sufficient to ensure the increase of the level of social responsibility. Also, there is the opinion that this type of engagement has no obvious utility, in the context in which the investors' decisions are not based in the context of such an assurance engagement. However, the very high level of responses supports the assertion that practitioners want greater involvement in the field of auditing non-financial statements to support the increased level of social responsibility.

*Q4: Will the involvement of financial auditors in assurance engagements by following ISAE 3410 increase the quality of statements regarding greenhouse gases?*

A proportion, respectively over 75%, believe that the involvement of financial auditors can lead to an increase in the quality of GHG declarations, in compliance with the requirements imposed by ISAE 3410 standard. implicitly leads to an increase in the quality of GHG statements.

**Q5: Do you consider that the value offered for an engagement accomplished by following ISAE 3410 could be higher than the price for an assurance engagement that would have a financial-accounting subject?**

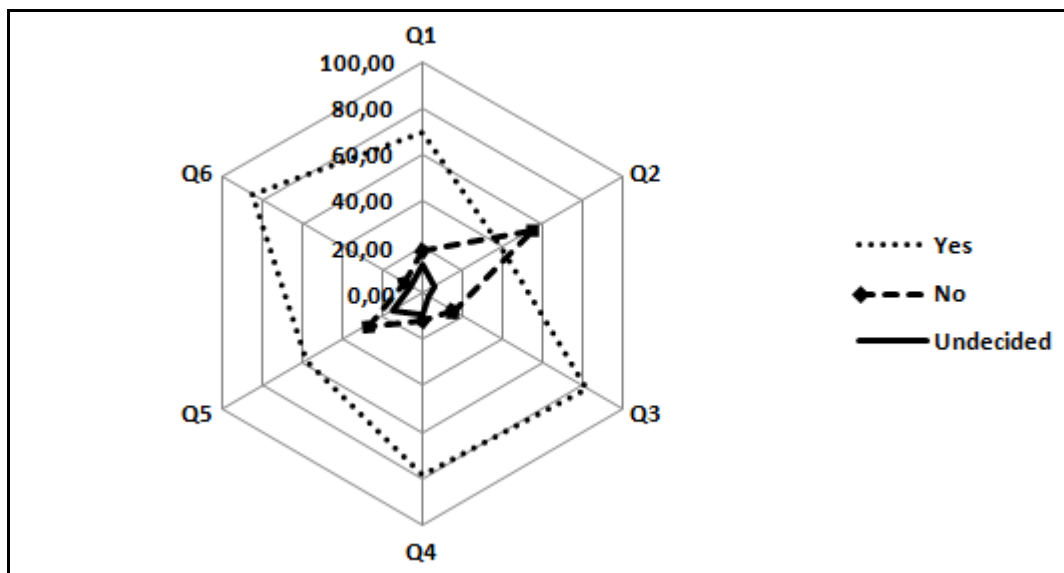
About 60% of respondents think that the price of such engagements could be higher than the price of a regular financial audit engagement. There were also nuanced answers, which emphasized the need for the price of these assurance engagements to be correlated with the level of expertise, the estimated time budget, the time accomplished in the engagement accomplishment, the risks assessed, and correlated with the client's budget. By the proportion of the answers received from the respondents, we can evaluate that they understand correctly that this type of assurance engagement, requires an increase of the resources used to carry out the engagement, and implicitly of its costs.

**Q6: Do you consider that the impact of greenhouse gas emissions on climate change is a real effect?**

The proportion of affirmative answers regarding the perception of the majority of the respondents that there is a real impact of greenhouse gas emissions on climate change is over 80% having the highest level of confidence.

Conclusion of answers to the questions (Q1 – attitude towards audit risk, Q2 – need to collaborate with other experts, Q3 – social responsibility, Q4 – attitude towards the quality of non-financial information, Q5 – financial perspective of assurance engagements, Q6 – involvement in environmental issues) can be represented synthetically using a radar graph, as shown in **Figure no. 2**. The way of presenting multivariate data in a two-dimensional form – through axes starting from the same point – indicates that the respondents have a predominant interest in reducing the risk of audit, of the increasing involvement with the environmental issues, of the social responsibility from the perspective of the quality of the non-financial information declared by the corporate managers regarding environmental aspects.

**Figure no. 2. Representation of the results of the questionnaire**



Source: Author's work, 2020

## 5. Conclusions

The emergence of the ISAE 3410 standard offered financial auditors the opportunity to carry out new types

of assurance engagements. This represents a major opening in the field of financial audit activity. The diversification of the field approached requires the enlargement of the audit team by including



environmental specialists, or engineers (multi-disciplinary). The study shows that there is a potential for carrying out assurance engagements regarding greenhouse gas declarations, in the context of the existence of official reporting requirements, of a trading market for GHG emissions certificates, but also the voluntary reporting initiative. Based on the results obtained, we consider that the involvement of the auditing practitioners in carrying out such engagements leads to the increase of the credibility of the specific reports, having an immediate consequence in improving the decision in the environmental policies. Also, the existence of a control environment for the financial audit activity offers the possibility of delivering reports that can have a high-quality level. It has to be studied in perspective, if this kind of services will lead to an increase in the cost of the assurance services offered for this purpose, this may represent a limitation of the service offer. The ISAE 3410 standard can be used by audit practitioners, but also by other professionals who carry out this type of assurance engagements, provided that the quality conditions required by ISQC1 or the educational conditions are met. The theme of the assurance engagements carried out by following ISAE 3410, creates the opportunity of statistical research having as object of study the entities that fulfil the criterion of the number of employees. This research could have as an object of analysis, the existence or the

incidence in the non-financial reports realized at the end of 2019, of the environmental issues, regarding the greenhouse gases. Following the use of the questionnaire with questions that address the objectives of the research, specific conclusions were obtained for the audit services market in Romania. The responses received from the target group made up of financial auditors and representatives of the academic environment, highlighted different aspects of their perception on the application of this type of assurance engagement. Thus, the participants in this questionnaire presented the prevailing opinion that this type of assurance engagement is advisable to be a reasonable assurance engagement, as it is necessary to use experts within the audit team, to achieve a level of social responsibility and to increase the quality of the non-financial statements. We identified the need to carry out this type of engagement within complex multi-disciplinary teams, but also to implement procedures on a statistical basis, such as the application of Benford's Law. Also, the majority opinion is that the price of such engagements will be higher than for another type of financial audit engagement. In overwhelming proportion, respondents believe in the impact of greenhouse gas emissions on climate change and want financial auditors to be involved in this process of auditing non-financial statements.

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