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SEMINAR – AUDITING THE FINANCIAL CRISIS

RESPONSE OF THE ICELANDIC NATIONAL AUDIT OFFICE TO THE FINANCIAL AND ECONOMIC CRISIS

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Moderator

Ladies and gentlemen

First of all, I would like to thank the organisers of this Congress for giving me the opportunity to address the seminar. It is truly an honour for me.

In my short presentation I will try to give you an overview of the actions taken by the Icelandic National Audit Office (henceforth referred to as the INAO) in response to the economic and fiscal hardships following the collapse of the Icelandic banking system in 2008.

As you may remember, Iceland was especially hard hit by the crisis on the international capital markets in 2008. The reason being that the Icelandic banks had borrowed heavily on the markets in the years leading up to the crisis. Already in 2007 the banks were experiencing severe difficulties in refinancing their liabilities. The situation got worse in 2008 and when the markets went into deep freeze mode following the fall of Lehman Brothers in mid-September it was really "game over" for the Icelandic banks. To make a long story short, in the first weeks of October they all went insolvent and were taken over by resolution committees appointed by the Icelandic Financial Supervisory Authority.

Total liabilities of the Icelandic banks amounted to more than 100 billion US dollars on the eve of their collapse. To put this figure into perspective, the GDP of Iceland is currently only about 15 billion US dollars. So it's hardly surprising that relative to the size of the economy the Icelandic bank collapse is the largest suffered by any country ever in history. As a result, the Icelandic state had to shoulder enormous costs and liabilities. For example it had to completely refinance the Central Bank

and its foreign currency reserve. It also had to invest large sums of money to keep the state owned Housing Financing Fund and several other financial institutions alive. On top of that, costs in the welfare system soared as unemployment rose to record levels. At the same time there was a sharp decline in state revenue as the economy went into recession. Total revenue fell around 8% of GDP between 2007 and 2009. The Icelandic state was almost debtless in 2007 but now it is estimated that its debts amount to around 80% of GDP, and then we are excluding various off-balance-sheet liabilities such as pensions etc.

Needless to say this turn of events put an enormous pressure on public finances. In response, the government was forced to seek ways to cut spending and introduce various austerity measures. Between 2007 and 2012 spending on core operations and services of the state were cut by more than 15% in real terms.

The crisis created some unique challenges for the INAO. I will now give a short overview of how the INAO has engaged these challenges. I will describe our actions in the field of financial auditing and in the field of performance auditing. But first of all I would like to mention our initial response to the crisis.

In the beginning of 2009 the INAO decided to make a special effort in monitoring the financial management of ministries and agencies. To this end, a special task force was created within the Office, consisting of employees from different organisational units, involving both financial audit and performance audit staff. On one hand, an assessment was made of ministries' monitoring of the planning and budget execution of agencies. On the other hand, various aspects of the financial management of agencies were examined. The intention was, among other things, to assess the possible effects of the cutbacks on their operation and service. The special monitoring project was launched early in 2009 and the results were published in two separate reports in June that year. They revealed several weaknesses in the financial management of ministries and agencies and contained numerous recommendations for improvements. A total of 3,700 work hours were spent on this project, which was around 4% of the Office's total active man-hours in 2009. Although there was no formal follow-up, it is our estimation that the project had a positive effect and helped ministries and agencies to come to terms with the changed environment following the crisis.

In the area of financial auditing the INAO's response to the crisis has first and foremost been to put more effort into the audit of balance sheet items and the audit of state revenue. The enormous increase in debts and liabilities has meant that the balance sheet of the state is much more complicated now than it was before the crisis. There has also been a considerable increase in off-balance-sheet liabilities. This development calls for a new approach on our behalf. We have therefore placed great emphasis on careful analysis and audit of balance sheet items and off-balance-sheet liabilities. The same goes for state revenue. Since the inception of the crisis numerous changes have been made to tax laws, both permanent and temporary, in order to raise money for the Treasury. Our response has been to strengthen our monitoring and audit of revenue items. In addition, we

have tightened our monitoring of ministries' and agencies' compliance with budget appropriations and the execution of the state budget in general. And last but not least, we have taken action to detect and prevent fraud in the system, since it is well known that the risk of fraud increases in times of economic downturn. In January 2009 all heads of state agencies received a letter from the INAO where they were urged to be alert to the risk of fraud within their respective organisations.

In the area of performance auditing the INAO's response has been to focus on issues and problems that ministries and agencies are facing because of the crisis. This includes studying the effect of budget cuts on operations and services, efficiency and effectiveness of public bodies. Also, emphasis has been placed on clearly delimited and concise audits, speed and timeliness. Furthermore, an effort has been made to enhance continuous monitoring and audit. We want to be alert and address the issues at an early stage and not in hindsight or long after the fact. The aforementioned focus points were defined in the INAO's strategy and operational plan for performance audit, prepared immediately in the wake of the crisis. The plan also defined several issue areas that were to receive special attention, among them public procurement of ministries and agencies, mergers and organisational reform, and human resources management. In the last five years the INAO has published numerous reports dealing with these issues. There have also been several audits of agencies which have experienced severe financial difficulties following the crisis.

The INAO did not launch comprehensive audits of the systems and organisations directly linked to the origin of the crisis: The Financial Supervisory Authority and the Central Bank. The reason is that in December 2008 the Icelandic parliament, Althingi, established a Special Investigation Commission to investigate and analyse the bank collapse. The Commission delivered its more than two thousand page long report in April 2010. It contained *inter alia* detailed analysis of the role of the regulators, pointing out serious weaknesses in their monitoring and supervision of the banking system. To avoid duplicity the INAO did therefore not conduct audits of these parties.

Finally, I would like to mention that the INAO itself has also been negatively affected by the changed fiscal environment. The Office's budget appropriations were cut by around 31% in real terms between 2008 and 2012. We have therefore been forced to cut down spending and introduce various austerity measures. The number of employees went from 49 to 42 in the aforementioned period which is a 14% reduction.

Of course this has not been easy. But by changing our emphases and working methods we have tried our best to serve parliament and the taxpayers in these difficult times – and thereby prove our value and benefits for Icelandic society as a whole.

Thank you.