



Auditing in the Wake of Iceland's Economic Crisis

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The Icelandic National Audit Office (INAO) is an autonomous monitoring body operating under the auspices of the Althingi, Iceland's Parliament. Its main role is to audit the financial statements of central government entities, carry out performance audits, monitor budget execution, and promote improvements in public financial management and the use of public funds. By year-end 2012, there were 42 employees working at the INAO, a reduction of 5 over the course of the year due to budgetary constraints. It should be kept in mind that Iceland, with its population of 320,000, is one of the most sparsely populated countries in Europe.

The Collapse of Iceland's Banks in 2008

Before the crisis caused by the collapse of the country's three largest banks in the autumn of 2008, Iceland's fiscal health was quite good. The country had a budget surplus, and significant amounts were set aside into the government employee pension system. Also, a large proportion of central government debt had been repaid; by the end of 2007, the debt level was approximately 44 percent of GDP (and none if government monetary assets were deducted). After the advent of the crisis, the measures the government employed initially to aid the banking system and afterwards when such attempts failed to sort out the resulting mess had an enormous impact on the operations and financial position of the country.

Following the collapse of the banking system, government revenues plummeted and, at the same time, expenditures sharply increased. This resulted in budget deficits and debt accumulation. Capital controls were introduced, and the government was forced to turn to the International Monetary Fund, the Nordic countries, and Poland for foreign

Editorial

loans to shore up Iceland's foreign exchange reserves and avoid defaulting on existing loans. By the end of 2011, central government debts amounted to 118 percent of GDP. Budget deficits have been substantial since 2008 but have decreased year by year as taxes have been raised and austerity measures to cut spending have been introduced. The crisis has also greatly influenced public debate and the attitude and trust of the general public towards financial institutions and their monitoring bodies—such as the Financial Supervisory Authority and the Central Bank—the cabinet, and the Althingi.

Financial Audit in the Wake of the Crisis

The spending limits of most government bodies have been reduced to cope with the fiscal gap and are now seldom raised by supplementary budgets later in the year. These cutbacks have led many public bodies to restructure their operations to make them more economical and efficient. Reforms of this kind have enabled many agencies to continue providing acceptable levels of service. Managers have been encouraged to think innovatively about how to make the best use of their budgets and this is more and more reflected in the way projects are prioritized. This is an achievement in itself and should be maintained and firmly established. However, large cutbacks will, in the long term, inevitably lead to reductions in the number of employees and reduced services.

Experience tells us there is an added risk of fraud and financial irregularities when public bodies and their employees face financial difficulties. Auditing needs to take this into account and increase its focus on risk analysis and risk assessments in this area. The INAO has brought this issue to the attention of managers of departments and public agencies and asked them to be on guard against possible incidents of this kind.

The INAO has also highlighted the need for stricter accounting practices regarding the way liabilities, obligations, and commitments are reported in the central government accounts in order to ensure they are fully disclosed when incurred instead of only when they become payable. For example, this is true for financial leases and various public-private partnerships. Only by adhering to strict accounting standards can we get the full overview of the state's activities and the financial position of the Treasury. The government accounts now are in essence based on modified accrual accounting principles. For example, they recognize the full purchase price of property, plant, and equipment as an expense when purchased instead of recognizing them as assets. In some cases, this has discouraged government agencies from making direct investments in favor of various lease arrangements. A new up-to-date accounting framework, based on international accounting standards, is now being considered in connection with the adoption of a new organic budget law over the coming months.

Prior to the crisis, major banks and other financial institutions were privately owned and, therefore, the INAO had no role in auditing their accounts and monitoring their operations. However, after the collapse of the banking system, the government acquired a substantial stake in most banks and the INAO became responsible for their audit. This took a lot of INAO's time in late 2008 and well into 2009. After that, audit companies affiliated with the major international audit firms were hired to conduct the audits on behalf of the INAO. Two of the banks were subsequently sold, and some

of the smaller state-owned banks merged with them. The INAO auditing role in the banking sector has therefore been scaled back to the audit of one commercial bank and several savings and loan institutions.

Every year, the National Audit Office reports to Althingi about its audits of public bodies and the central government accounts. Comments relating to the collapse of the banking system have been prominent in these reports in recent years.

Performance Audit in the Wake of the Crisis

Following the events of 2008, the INAO changed the methods it uses to select assignments for performance audit. More emphasis is now placed on concurrent audits in addition to traditional ex post audits. Also, emphasis is placed on risk analysis of programs, agencies, and projects. Special attention has been given to problems the authorities and agencies are facing because of diminishing revenues, contraction in operations, and reorganization of services.

The working methods applied in performance audit have also changed because of the uncertainty and changes in the public sector following the crisis. Special emphasis is placed on flexibility in study selection, clear focus, speed, cooperation with financial auditors, and increased visibility. In addition to traditional audits that seek to give a comprehensive and detailed view of programs or projects, the INAO has also carried out several audits having much a narrower focus or covering specific problems. Finally, reporting has been revised with the aim of making reports shorter, better structured, and more readable than before. The aim is to provide Parliament with timely and usable conclusions and recommendations. The INAO formulates 3-year plans for its performance audit activities that are revised annually.

We Still Have a Ways to Go

We have not yet put the crises behind us, and there still are major challenges to be tackled. There are many lessons to be learned from the crisis for all those engaging in public policy making, financial management and control, and auditing. We must make sure that at all times we have relevant, accurate, and timely information on public finances presented in a way that anyone can understand; risks need to be carefully assessed and kept at an acceptable level; and contingency planning must take place. As humans we are prone to overconfidence and wishful thinking, but we must constantly remind ourselves not to forget to use sound, carefully reasoned judgment based on facts. In many ways, the banking and debt crisis Iceland and many other countries faced in 2008 and afterwards repeats a pattern of similar events that happened all over the world during the 1980s and 1990s. It could have been avoided, or at least not been as bad, had that experience been fully understood and translated into public policy.

The INAO was affected by what happened through both tighter financial constraints on its operations and changes in its priorities. We have not seen the end of that process, and it still remains a challenge to offer our staff a positive working environment.

The INAO wishes you a happy new year.

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