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Screening report
Iceland

Chapter 32 – Financial control

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I. CHAPTER CONTENT

This chapter contains two main policy areas, namely (a) public internal financial control (PIFC) and external audit (EA) and (b) the protection of the EU's financial interests and the protection of the Euro against counterfeiting. With regard to the first area, there is no EU legislation. Instead, countries commit themselves to adopt international control and external audit standards and EU best practices. For this purpose, a PIFC Policy Paper with a short and long term action plan that includes realistic deadlines is adopted by the candidate country after being discussed with the European Commission.

PIFC is a comprehensive concept for upgrading internal control systems. PIFC and EA essentially relate to the entire public budget, in particular central government income and expenditure, including foreign funds. However, the more specific rules for managing and controlling EU funds are treated under the relevant accession negotiation chapters. The PIFC concept is based on three principles, 1) managerial accountability carried by sound financial management and control (FMC) systems, 2) functionally independent internal audit (IA) and 3) centralised harmonisation of the FMC and IA systems.

Regarding external audit, countries apply the norms defined by the International Organisation of Supreme Audit Institutions – INTOSAI, in particular its Lima Declaration of Guidelines on Auditing Precepts, which foresees supreme audit institutions that are functionally, institutionally and financially independent.

The other policy area under this chapter concerns the protection of EU financial interests. Article 325 TFEU requires Member States to protect the European Union's financial interests in the same way as national financial interests. First, it comprises operational cooperation of Member States, which must have the capacity to cooperate effectively with the European Commission and to communicate all suspected cases of irregularities and fraud. They must ensure the protection of EU funds at an, at least, equivalent level to the protection of national funds. Member States are also obliged to assist and co-operate in on-the-spot checks carried out by European Commission services. As some of this *acquis* applies directly to Member States and thus does not need to be transposed, effective co-operation and coordination structures and capacities are set up. In order to facilitate the required cooperation by future Member States, the nomination of national anti-fraud cooperation services – AFCOS – as a single contact point for the European Commission is recommended. Furthermore, this part of the chapter also includes the Convention on the protection of the EU's financial interests ("PIF-Convention") and its three protocols, including the harmonisation of penal law related to those crimes and the reinforcement of cooperation.

Finally, this part of the chapter comprises the non-penal aspects of the protection of the Euro against counterfeiting. The Geneva Convention for the Suppression of Counterfeiting Currency outlines the relevant principles, such as the prohibition of metals or tokens similar to Euro coins, the obligation for financial institutions to withdraw counterfeit notes and coins and effective anti-counterfeiting bodies and procedures.

This chapter is not relevant under the EEA.

II. COUNTRY ALIGNMENT AND IMPLEMENTATION CAPACITY

This part summarises the information provided by Iceland and the discussion at the screening meetings. Iceland indicated that it can accept the relevant standards and *acquis* regarding internal financial control.

II.a. Public internal financial control (PIFC) and external audit

Iceland's public budget system features a central treasury and central accounting. The budget is spent by 10 ministries and implemented through 216 agencies and the 76 independent municipalities. Apart from transfers received from the central government, the latter also dispose of some own income including from taxes. The ministries have financial autonomy and they are responsible for efficient use of funds under their authority, but the Ministry of Finance has the overall supervision of the execution of the budget, giving horizontal advice and instructions that may include certain aspects for the internal control environment. These are complemented by guidelines by a Financial Management Authority. Each ministry has a financial management department, which is responsible for assessing the financial operations.

The Ministry of Finance monitors budget implementation by agencies on a monthly basis and can also inspect accounts. The minister is advised by a treasury accounts committee. Serious suspected cases of irregularities and fraud are reported to the National Audit Office, which performs the function of the Supreme Audit Institution of Iceland.

Iceland does not have a PIFC Policy Paper in place. During the second semester of 2010, Iceland performed an initial assessment of the possible gaps and weaknesses of its PIFC system. Iceland states that this has shown a need for improvements in the overall internal control environment. There is no specific PIFC legislation, only certain aspects of financial management and control are covered in different laws and regulations. With regard to internal audit, while the six larger public spending agencies have internal audit functions, neither they nor the ministries and other agencies are subject to harmonised public internal audit rules defined in an internal audit law or guidelines.

Iceland aims at harmonising its PIFC system with international standards and EU best practice. Iceland states that a further gap analysis is needed; a PIFC policy paper will be drafted that will contain an action plan outlining in more detail the required legal and institutional changes. The process of further development of PIFC is to be led by the financial management department in the Ministry of Finance, which is planned to become the central harmonisation unit. Concrete legal and institutional reforms are envisaged. Iceland states that given the small size of the majority of its agencies, about half of them having less than 30 employees, it is considering the establishment of a centralised internal audit function in addition to the already existing internal audit units in larger entities. It is likely to be located within the financial management authority. This centralised function could then be used to perform audits for those organisations which are too small to have their own internal audit.

With regard to external audit, Iceland's National Audit Office (INAO) is an operationally and functionally independent body operating under the auspices of the Icelandic parliament (Alþingi). The independence of the INAO is not anchored in the Icelandic Constitution, but Iceland states that it is considering doing so. The Alþingi's presidential committee appoints the Auditor General for a period of six years. Its budget is submitted to the Alþingi by the Minister of Finance, but the Auditor General is entitled to present amendments.

The INAO's remit covers revenues, expenditure, assets and liabilities of all ministries, state bodies and companies where the state has majority share. The INAO carries out both financial and performance audits. The municipalities are covered only to the extent there are joint operations with the central government. Municipalities issue their own external audit, mostly by private firms. The INAO has been performing an internal audit function for the housing fund and for the Central Bank, but this practise is to be discontinued by the end of 2011 at the latest.

The INAO's audit reports are publicly accessible via the internet. While the Alþingi can request targeted special reports, it does not regularly follow up on INAO reports. A bill proposing changes to the parliamentary committee structure, including improvements concerning this follow up, is pending in the Alþingi.

The INAO has not yet developed a comprehensive strategy paper, including an action plan, for its future tasks. Since 2010, the INAO is reviewing its audit methods, its structure and its performance measures. In 2011, it plans to fully adopt INTOSAI international audit standards (ISSAI) as well as electronic processing and filing of all data. It considers highly qualified staff and low employee turnover as its strengths, while it sees a need for improvements in particular in selecting its audits on better risk analysis. The INAO has acceded to the network of European Supreme Audit Institutions.

II.b. Protection of EU financial interests

Iceland's legislation protects public funds without distinction of their origin. While fraud is criminalised, Iceland has not legally defined irregularities, fraud and corruption, but works on the basis of customary principles. Regarding cooperation for on-the-spot checks by European Commission investigators, Iceland states that it intends to fully support such activities. However, no specific rules are defined to regulate the cooperation with European Commission investigators, in order to ensure that they – as well as evidence produced by them – are treated like national ones. The same applies for the obligation to safeguard evidence, to actively cooperate with and participate in European Commission inspection missions, and to support such missions, if requested, vis-à-vis economic operators. Currently, there are no plans for further alignment. Iceland states that it considers designating the Economic Crime Department at the National Commissioner’s Office as the national anti-fraud coordination service (AFCOS) for the cooperation with European Commission's Anti-Fraud Office (OLAF). It is to be noted that this Department will be merged with the Special Prosecutor’s Office by 1 June, pursuant to a bill prepared by the ministry of interior. This new entity will take over the tasks of the Department. A consultative committee for reviewing the organisation and procedures of investigation and prosecution relating to economic crimes will be appointed, which is expected to also take a stand on the location of AFCOS and the organisation of its activities.

With regard to the protection of the Euro against counterfeiting, Iceland states that its legislation provides for a definition of such acts referring to both notes and coins. Moreover, the Icelandic police investigate cases of counterfeited currency, including forensic work and the gathering and distribution of information on counterfeiting; it also cooperates with Interpol, Europol, and the Icelandic Central Bank. Reporting of counterfeit bank notes is compulsory under Icelandic law and there is no distinction between domestic and other currency. Failure to report a suspected counterfeiting activity is a crime. Cooperation with the Member States, the European Commission and the ECB takes place in terms of exchange of information (via Interpol and Europol).

Thus, although it has not ratified the Geneva Convention for the Suppression of Counterfeiting Currency, Iceland considers that its legislation is compatible with it. However, a further study on the Convention's compatibility with the Icelandic legislation will be carried out, in order to evaluate the need for its ratification.

Moreover, as a proportion of GDP, and therefore even more in absolute terms, cash circulation in Iceland is much smaller than in the EU. This is due to the extensive use of credit cards, debit cards and internet banking.

III. ASSESSMENT OF THE DEGREE OF ALIGNMENT AND IMPLEMENTING CAPACITY

As regards the relevant international standards and the *acquis* under this chapter, Iceland's level of alignment is at a satisfactory level. However, a PIFC gap assessment and policy paper need to be prepared and Iceland has yet to take steps towards the completion of legislative alignment.

III.a. Public internal financial control (PIFC) and external audit

Iceland's public internal financial control system works satisfactorily. However, it concentrates mainly on budgetary and accounting controls. The relevant legal framework is fragmented and consequently, financial management and control concentrates on legality and regularity of financial transactions with less explicit emphasis on economy, efficiency and effectiveness. The internal audit function has not been systematically developed. Currently, also the Iceland's National Audit Office (INAO) undertakes certain responsibilities in the area of internal audit, which is not fully in line with international standards.

In relation to its implementing capacity, the central harmonisation unit needs to carry out its coordination responsibilities adequately and timely. The government needs to formalise the most relevant procedures and principles relating to internal control as outlined in the relevant international standards, support the financial services in spending institutions and guarantee the training and certification of internal auditors.

With regard to external audit, the INAO is operationally and functionally independent but independence is not guaranteed in the Constitution. The scope of the INAO's finance and performance audit work is limited to central government level; the INAO's mandate does not include systematic audit of municipalities. The envisaged changes to relevant legislation should contribute to the parliamentary follow-up to the INAO's audit reports. Moreover, the INAO needs to develop a strategic development paper.

The Commission notes that Iceland is considering to anchor the independence of the INAO in the Constitution. Moreover, the INAO needs to cease performing any type of internal audit function. The INAO envisages doing so by the end of 2011 at the latest.

III.b. Protection of EU financial interests

In order to comply with the requirements of the PIF-Convention and its protocols, Iceland's criminal law identifies certain offences. However, Iceland still needs to undertake further efforts to align its provisions with the Convention and its Protocols. In particular, this concerns the penal law, which should provide definitions of irregularities, fraud and corruption in line with the EU acquis. Furthermore, it needs to be assessed whether the Icelandic criminal law provides sufficiently for concepts to ensure that heads of businesses or legal persons can be held liable for such offences.

Iceland needs to nominate the service responsible for the coordination and cooperation with the European Commission in the fight against fraud and the protection of the EU financial interests.

With respect to the protection of the Euro against counterfeiting Iceland has sufficient expertise in relation to analysis and classification of counterfeited notes and coins. Considering the comparatively low risk of counterfeiting due to the limited cash circulation, there is also an adequate level of police capacity. However, until the time of accession, direct communication needs to be established with the European Central Bank. Iceland needs to implement the relevant parts of the Geneva Convention for the Suppression of Counterfeiting Currency. (R.E: This latter point is relevant until the closure of the chapter.)