

# BOARD OF DIRECTORS

Annual Activity Report of the EIF Audit Board  
for the 2015 financial year

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## EXECUTIVE SUMMARY

### MANDATE OF THE AUDIT BOARD

The Audit Board has the statutory responsibility (Article 22 of the Statutes) to annually confirm to the members of the General Meeting that the balance sheet and profit and loss account of the European Investment Fund ("EIF" or the "Fund") give a true and fair view of the financial position of EIF with respect to its assets and liabilities, and of the results of its operations for the financial year under review.

Complementary to this responsibility, the Audit Board shall also confirm (Article 18 of the Rules of Procedure) that the operations of EIF have been carried out in compliance with the formalities and procedures laid down in the Statutes and the Rules of Procedure.

The Audit Board provides these confirmations to the best of its knowledge and judgement.

### AUDIT BOARD APPROACH

In order to comply with its mandate the Audit Board relies on the work carried out during the eight meetings held in 2015/2016 (since the AGM in April 2015 to date) and, in particular, on the following sources of assurance:

- KPMG, mandated and appointed by the Audit Board as external auditor to audit the financial statements of the Fund, has issued an unqualified audit opinion on the EIF financial statements for 2015;
- The Internal Audit reports issued in 2015 and up to March 2016 including the 2015 Internal Audit Annual Activity report;
- The unqualified management assurance on the adequacy of EIF's internal control system included as part of the Internal Control Framework;
- Internal Audit assurance on EIF's internal control system.  
The Internal Audit opinion concluded that, based on the audit work performed, the controls in the audited areas, except for the matters described as Agreed Action Plans, were achieved during the year, and Internal Audit considers that the overall residual risk to EIF from outstanding AAPs is medium. Internal Audit has further confirmed that it considers the ICF to be appropriate having regard to the nature and scale of EIF's business and that nothing came to its attention that causes it to believe that the assertion of reasonable assurance over the effectiveness of EIF's internal controls during the year, is not fairly stated.
- The confirmation received from the European Investment Bank (EIB) that services carried out by it on behalf of EIF for 2015 have been executed in line with the Treasury Management Agreement and the Service Level Agreement concluded between EIF and the EIB.

In relation to its confirmation that, to the best of its knowledge and judgement, the operations of EIF are carried out in compliance with the Statutes and Rules of Procedure, the Audit Board also relies on:

- Minutes of the meetings of the Board of Directors and the General Meeting;
- The work carried out by the various EIF functions such as Risk Management, Compliance and Operational Risk, and
- The compliance opinion in the Compliance Annual Activity Report 2015.

A target of closing at least 60% of Agreed Action Plans (AAPs) contained in Internal Audit reports issued in the previous two years has been set. The Audit Board notes that actual performance was 79% at 31 December 2015 which met the target of 60%. This confirms the continued priority placed on the closure of AAPs by Management. The Audit Board notes that, out of the 23 AAPs open at year end, only one,

relating to back-testing of input parameters for the Guarantees and Securitisation internal rating model, has been graded by Internal Audit as high risk. The Audit Board has received specific assurance from the Chief Executive that regular back-testing of key input parameters for the model is being implemented and will be completed in due time. In addition, three AAPs, relating to compliance issues, were overdue at year end. Whilst the points raised related to documentation, as opposed to breaches of compliance controls, the Audit Board notes the importance of satisfactory action in this area so that it can give the required assurances. The Audit Board will continue to monitor performance, and give priority to compliance regular updates to ensure that relevant risk areas are addressed.

Throughout the year, in the course of its work, the Audit Board has reviewed the accounting judgements made by Management and discussed them with Management and KPMG. The Audit Board also reviewed the audit approach adopted by KPMG so as to satisfy itself that it was appropriate. During the course of the 2015 audit work, the Audit Board has received regular business updates from Management which provided valuable insight into EIF's business environment.

Finally, the Audit Board has evaluated its performance in 2015 and, as in preceding years, can confirm that all responsibilities outlined in the Audit Board Charter have been carried out. The Audit Board continues to strive to improve its own effectiveness and to increase the level of oversight it exercises. It derives its assurance from the work that the Audit Board carries out throughout the year. It also formally assesses whether operations of EIF have been carried out in compliance with the formalities and procedures laid down in the Statutes and Rules of Procedure.

## AUDIT BOARD CONCLUSIONS FOR 2015 AND AREAS OF FOCUS FOR 2016

The Audit Board confirms, on the basis of the audit work carried out, the unqualified audit opinion given by KPMG, the assurance statement provided by Management and the reporting received from EIF's control functions, that to the best of its knowledge and judgement:

- the operations of the Fund have been carried out in compliance with the formalities and procedures laid down in the Statutes and the Rules of Procedure and,
- the financial statements of EIF, which comprise the statement of financial position as at 31 December 2015, the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information, give a true and fair view of the financial position of the Fund as regards its assets and liabilities, and of the results of its operations for the financial year under review.

The Audit Board would like to highlight the following areas for focus in 2016:

- The external audit tender process, which is currently under way, to select the external auditors for 2017 and later years;
- Oversight of the continued evolution of risk management, internal control and assurance and audit mechanisms;
- Continued oversight of the tail-end funds strategy, as well as any new initiative developed by EIF;
- Progress in the implementation of AAPs.

# REPORT

## 1. INTRODUCTION

The Annual Activity Report is prepared in accordance with the EIF Rules of Procedures and the Audit Board Charter, and it will be presented to the shareholders' Annual General Meeting. The report provides an overview of the Audit Board activities during the period since the last Annual General Meeting. The Audit Board has also provided its opinion on the EIF financial statements for the financial year 2015 in a separate statement contained in the EIF Annual Report.

## 2. AUDIT BOARD RESPONSIBILITIES AND ACTIVITY

Pursuant to Article 22 of the Statutes, the Audit Board audits the accounts of EIF. In line with the Statutes and Rules of Procedure (modified in this respect in February 2009) it is the task of the Audit Board to verify that EIF operations have been carried out in compliance with the Statutes and Rules of Procedure and to annually confirm, to the best of its knowledge and judgement, that the balance sheet and profit and loss account give a true and fair view of the financial position of EIF as regards its assets and liabilities, and of the results of its operations for the financial year under review (Rules of Procedure, Articles 17 and 18). To discharge these tasks, the Audit Board may have recourse to external auditors, which it designates after consultation with the Chief Executive and the Board of Directors (Rules of Procedure, Article 19). It also relies on the work of Internal Audit, Risk Management and the Compliance function.

## 3. APPOINTMENT TO AND MEMBERSHIP OF THE AUDIT BOARD

Pursuant to Article 20 of the Rules of Procedure, the General Meeting approved the appointment of Mr. Jacek Dominik, as a member of the Audit Board on 26 October 2015. Mr. Dominik, who is currently also a member of the EIB Audit Committee, has been nominated to the Audit Board by the EIB to take over the mandate previously held by Ms. Jakobsen following her resignation in May 2015. This dual EIB and EIF Audit Board membership provides a useful link between both boards. Mr. Dominik's term of office will end on the day of the 2017 Annual General Meeting.

Also pursuant to Article 20 of the Rules of Procedure, the General Meeting approved the reappointment of Mr. Dries as a member of the Audit Board until the day of the 2018 Annual General Meeting.

The other members being: Mr. Borg, former CEO of Bank of Valletta, acting as the Audit Board Chairman and Mr. Smyth, former Secretary and Director of Audit Office of the Comptroller and Auditor General in Ireland, as Audit Board alternate member.

## 4. REVIEW OF AUDIT WORK PERFORMED IN EIF

### 4.1 Audit of the Annual Financial Statements

Under the mandate of the Audit Board, KPMG has audited the financial statements of EIF, which comprise the statement of financial position as at 31 December 2015, the statement of comprehensive income,

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statement of changes in equity, cash flow statement for 2015, and a summary of significant accounting policies and other explanatory information.

The mandate given by the Audit Board to KPMG is to express an opinion on the financial statements based on their audit. KPMG considers that the audit evidence they have obtained is sufficient and appropriate to provide a basis for their audit opinion. In their opinion, the financial statements give a true and fair view of the financial position of EIF as of 31 December 2015, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union.

During the course of the year, the Audit Board has held regular meetings with KPMG. During these meetings the Audit Board was updated with regard to the audit approach, the audit progress and developments. The Audit Board has used these sessions with KPMG to review their work and to satisfy itself that the audit approach was acceptable. In addition, a private session has also been held with the Partner in charge of EIF's audit. The Audit Board has been assured by KPMG that the audit process went as planned with the full support of EIF staff. The Audit Board is satisfied with the quality of external audit work performed and has used the results of this work to formulate its own opinion.

The Audit Board has had preliminary discussions with KPMG on their Management Letter and expects to receive it shortly. The Audit Board will monitor the implementation of the Management Letter recommendations.

The Audit Board notes that for 2015 co-operation has taken place between KPMG and EIF Internal Audit in an appropriate manner.

KPMG has confirmed to the Audit Board its independence and that KPMG did not provide any type of non-audit services to EIF that could compromise its independence.

### 4.2 Internal Audit

Internal Audit in EIF is outsourced to the EIB Inspectorate General. Internal Audit covers the significant activities and specific tasks undertaken by EIF on a risk-based three year cycle. In December 2015, the Audit Board approved the Internal Audit rolling work programme for the period 2016–2018.

#### 4.2.1 Internal Audit Reports and Assessment of Internal Audit Work

The Internal Audit Annual Activity Report was made available in February 2016 and has been taken into consideration in preparing the present report. The Audit Board has also noted the declaration of independence contained in the report which is provided on an annual basis by the Head of Internal Audit as required under the International Professional Practices Framework (issued by the Institute of Internal Auditors, Standard 1110 - "Organisational Independence").

In total five audit assignments were completed by Internal Audit in 2015, with the corresponding reports being finalised, received and discussed with the Audit Board during the year 2015. One assignment on the eFront application was on-going at 31 December 2015 with the report being issued in February 2016. In addition, progress reports have been provided on on-going assignments during Audit Board meetings throughout the year. The Audit Board is satisfied with the quality of the audit work performed and the reporting received.

As in the previous two years, an internal Quality Assurance Review (QAR) of the Internal Audit function was conducted by a senior member of the Internal Auditor team. The overall conclusion is that the

function operates professionally and “Generally Conforms” to the selected IIA Standards falling within the scope of the 2015 QAR. Minor areas of improvement were identified in relation to the enhancement or update of certain procedures.

The work carried out by Internal Audit on the EIF Internal Control Framework is covered in section 5 of the report.

#### 4.2.2 Status Review of Audit Recommendations and Agreed Action Plans

Recommendations from Internal Audit and from KPMG are recorded as Agreed Action Plans (AAPs), with target dates that are fixed in consultation with Management. The matters giving rise to the AAPs are graded as high, medium or low risk. The follow up and monitoring of control issues and their corrective actions is a fundamental part of the audit cycle.

On the basis of quarterly Internal Audit updates, the Audit Board reviews the status of audit recommendations. A target implementation performance of at least 60% has been set, as a ratio between the number of AAPs open at the quarter-end and the total AAPs issued during the last two years. From the review as at 31 December 2015 the Audit Board notes EIF’s implementation performance of AAPs of 79% which surpasses the target of 60%. This confirms the continued priority placed on the closure of AAPs by Management. There is only one outstanding high risk AAP as at 31 December 2015. It arises from the EREM – ABS Credit Enhancement Instrument audit and concerns the implementation of back-testing aimed at comparing the estimated model input parameters with actual outcomes during the life of the investment. The Audit Board has received specific assurance from the Chief Executive that regular back-testing of key input parameters for the Guarantees and Securitisation internal rating model is being implemented and will be completed in due time.

The Audit Board notes that three medium-risk audit points were overdue at the end of December 2015. These AAPs involve compliance issues identified during the equity deal origination audit issued in February 2015 and relate to the adequacy of the documentation supporting ex-ante compliance controls on equity investments. Whilst the points raised related to documentary evidence of controls, as opposed to breaches of compliance controls, the Audit Board notes the importance of satisfactory action in this area so that it can give the required assurances. The Audit Board will continue to monitor performance, and give priority to compliance regular updates to ensure that relevant risk areas are addressed. Actions are underway to close these AAPs by the end of June 2016.

The 22 remaining open AAPs are graded as medium or low risks and the Audit Board will continue to monitor their timely implementation.

#### 4.3 Investigations

The Inspector General and the Head of Investigations report on a quarterly basis to the Audit Board on the status of investigations in cases of alleged fraud, misappropriations etc. with an assessment of the risks for EIF.

#### 4.4 Evaluations

In September 2015, the Evaluation Division (which is under the responsibility of the Inspector General) introduced the work of the division to the Audit Board and explained their main objectives and reporting procedures.

The division indicated to the Audit Board that the evaluation on Credit Enhancement for Securitisation would be completed in 2016 and that Mid-term evaluations of EIB's Partnership and Mandates and of EFSI would be performed. The Audit Board looks forward to obtaining the results of this work.

## 5. INTERNAL CONTROL FRAMEWORK AND OTHER ADDITIONAL ASSURANCE

The Internal Control Framework (ICF) exercise reflects the results of the risk self-assessment exercise which translated into a risk control matrix. The principal objectives of the risk control matrix included in the ICF are to identify the key operational risks relating to the business activities undertaken by EIF and to identify and review, at a macro level, the internal control processes implemented to ensure that risks are mitigated and/or minimised to an acceptable level. The preparation of the risk control matrix has been integrated into the EIF operational risk management framework under the coordination of the Corporate Risk Management Division. Initiatives have started in 2015 to also integrate specific parameters of third party mandate related risk profiles as part of the ICF.

In line with established practice, the Audit Board has sought and received assurance from the Chief Executive by way of a representation letter that the ICF mitigates operational risks in all significant activities and that the ICF has been updated according to changes in business activities and as new processes and procedures are implemented. The Audit Board has also been assured in this letter from the Chief Executive that the controls designed to achieve these objectives are in place and, to the best of his knowledge, are operating effectively.

On 23 February 2016, Internal Audit provided an opinion on the ICF. This opinion concluded that, based on the audit work performed, the controls in the audited areas, except for the matters described as Agreed Action Plans, were achieved during the year, and Internal Audit considers that the overall residual risk to EIF from outstanding AAPs is medium. Internal Audit has further confirmed that it considers the ICF to be appropriate having regard to the nature and scale of EIF's business and that nothing came to its attention that causes it to believe that the assertion of reasonable assurance over the effectiveness of EIF's internal controls during the year, is not fairly stated.

A Service Level Agreement (SLA) and a Treasury Management Agreement between the EIB and EIF is governing the provision of certain services by the EIB to the Fund. In two different annual assurance letters, the EIB confirmed to EIF that the defined services had been carried out on the behalf of EIF appropriately. These letters also support the Management representation letter to the Audit Board.

Throughout the year, the Audit Board obtained assurance of the effectiveness of EIF's internal control and risk management as well as of its systems for monitoring compliance with relevant policies and procedures and the measures taken by Management as a result of its investigation of material incidents of non-compliance as outlined in the Audit Board Charter. The assessment process refers to the guidance outlined by the Financial Reporting Council Guidance on Risk Management, Internal Control and Related Financial and Business Reporting.

## 6. COMPLIANCE AND RISK MANAGEMENT

In May 2015, the Chief Executive decided to integrate risk management, operational risk and compliance into a comprehensive second line of defence function. The new department consists of four divisions: a newly established Corporate Risk Management Division, the Compliance Division, the Credit Risk Management Division and the Equity Risk Management Division.



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The Corporate Risk Management Division shall address risks related to EIF's treasury and liquidity activities, but also mandate-related risks and shall co-ordinate EIF's contribution to the Group risk reporting on the basis of the EIB Group Risk Management Charter. Furthermore, Corporate Social Responsibility and Operational Risk were integrated into the Corporate Risk Management Division.

EIF retained the advisory firm Oliver Wyman to review and benchmark the reorganisation against emerging practices in the market. The report concluded that the combination of Risk Management and Compliance is in line with market practices and contained various recommendations which are being implemented as presented to the Audit Board in February 2016. The Audit Board considers this review to be timely given the volume and the increased staffing of EIF and endorses its conclusions. These developments entail the need to ensure that risk management, internal control and the audit and assurance mechanisms upon which both Management and the Audit Board rely, evolve and keep pace with the needs of EIF's activity. The Audit Board will monitor this in 2016.

The reorganisation was also discussed with the Audit Board. During this process, the Audit Board invited the Group Chief Compliance Officer to express his views and questions on the consequences for the independence of the compliance function in EIF.

The Head of Compliance retains an individual direct and unrestricted access to the Board of Directors and to the Audit Board, including the right to request at least one annual private session.

The Audit Board considers it is important that the Compliance Division should be adequately resourced and therefore welcomes the recruitment in 2015 of a new Head of Compliance and a junior compliance officer; and of the upcoming hires in early 2016.

As regards the compliance and corporate risk management function, the Audit Board took note of the activities carried out by these divisions in 2015. The Audit Board noted, in particular:

- The revision of the Compliance Operational Procedure, which returns to a centralisation of compliance risk controls and lays the ground for the development of a compliance risk scoring.
- The on-going revision of the EIF Compliance Transactional Procedure in order to reflect a risk-based approach in line with the concept chosen in the upcoming 4<sup>th</sup> EU Anti-Money Laundering Directive.
- The efforts of the Mandate Risk Management unit to develop a Mandate Control Framework and a Mandate Risk Profiling; and the Treasury Risk Management work on the Treasury Risk Guidelines.
- The Sensitive Posts Procedure was finalised by end of March 2015. This procedure followed an Agreed Action Plan which arose in the context of the 2013 Fund-of-Funds audit. It related to general principles such as rotation of posts, or an annual declaration of conflict of interest for each holder of a sensitive post. The Chief Executive is responsible for defining the sensitive posts list following a consultation with Compliance and HR.

The Audit Board notes that during the reporting period 2015, EIF Compliance has not identified substantial risks of an integrity, reputational, or otherwise compliance-related nature.

## 7. EUROPEAN COURT OF AUDITORS

EIF, the European Court of Auditors (ECA) and the European Commission are parties to the Tripartite Agreement governing the procedures for the audit by the ECA of the value of the European Community's subscription to the capital of EIF. The Audit Board has not carried out any audit in co-operation with the ECA under the Tripartite Agreement in 2015.

The Audit Board met with the ECA on 1 December 2015. The discussions mainly focused on the business environment and activities of the ECA and EIF.

### 8. OTHER AUDIT BOARD ACTIONS IN 2015

#### 1. Auditor Board Charter

The Audit Board took the opportunity to update its 2006 Charter and it was approved by the General Meeting on 20 April 2015. The main amendments concerned were: the duties of an annual review by the Audit Board of EIF's internal control and risk management; the reception by the Audit Board of assurances from Management, Internal Audit and external auditors and the alignment of the Audit Board mission with the Statutes and the Rules of procedures.

#### 2. External Audit Tender Process

As KPMG's mandate reaches its end with the signature of the 2016 Financial Statements, a joint External Audit Tender process was launched by the EIB and EIF in 2015. The Contract Notice was published in the Official Journal of the European Union on 2 January 2016. Four candidatures have been received and are being analysed.

#### 3. Auditor Recruitment Policy

The Audit Board requested an Auditor's Recruitment Policy to be formalised by Human Resources with a view to ensuring how such appointments are made in a fully objective manner. The policy was issued in October 2015.

#### 4. Tail-end funds

The first portfolio secondary sale took place in 2015. The Audit Board closely followed developments in this area and took note of the fact that the tail-end funds represent 40% of EIF's active equity portfolio.

#### 5. Year-end transactions

The Audit Board monitored the 2015 volume of transactions and actions taken to avoid high year-end volumes and noted with satisfaction that the implementation of the 2015 EI activities were evenly spread over the year.

#### 6. Anti-fraud policy

EIF's anti-fraud policy, approved in March 2015 to align with EIB's equivalent policy, was reviewed by the Audit Board. The Audit Board noted the importance of having the necessary instruments and methods at the disposal of EIF should an investigation arise.

7. EIB-EIF Compliance synergy

The Audit Board followed developments regarding the achievement of greater synergies between EIB's and EIF's Compliance functions, through regular updates by the EIF Compliance Division and discussions with the EIB Group Chief Compliance Officer.

8. Audit Board Portal

The Audit Board launched a project to create an EIF Audit Board Portal, to store relevant documents and allow more efficient exchange among members.