



ANNUAL ACTIVITY REPORT OF THE AUDIT BOARD

TO THE GENERAL SHAREHOLDERS' ANNUAL MEETING

FOR THE 2005 FINANCIAL YEAR

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## 1. INTRODUCTION

This is the second annual activity report of the Audit Board of European Investment Fund ("EIF" or "Fund") presented to the Shareholders' Meeting of EIF. The activity report has been prepared expressly for use by the Shareholders' General Annual Meeting and provides a summary of the Board's activities during the period since the last General Annual Meeting. The Audit Board has also provided its opinion on the financial statements of EIF for the financial year 2005 in a separate statement.

## 2. EUROPEAN INVESTMENT FUND: MISSION AND MILESTONE DEVELOPMENTS

### 2.1. Background

#### **European Investment Fund**

Following a decision of the Board of Governors of European Investment Bank ("EIB") in accordance with article 30 of the Statute of EIB, EIF was established in 1994 as a financial institution with legal personality and financial autonomy (Article 1 of EIF's Statutes). The shareholders of EIF are EIB, the European Community, represented by the European Commission (EC), and various financial institutions from European Union (EU) Member States.

In June 2000, a decision was taken at the Fund's General Meeting to re-define the business focus of EIF. As a consequence, EIF was positioned as the EU's specialist financial institution for small and medium sized enterprises (SMEs). Currently, its business activities are participation in venture capital funds and the issue of guarantees, with a mission to facilitate the access to finance for SMEs.

As a result of the 2000 reform, EIB became EIF's main shareholder and EIF joined the EIB Group. EIF's integration into the EIB Group aimed at a cost-efficient identification of synergies between the two associated EU financial institutions. In this context, certain administrative functions were outsourced from EIF to EIB so that these functions could be performed on a group level; this applied, in particular, to treasury management, Human Resources administration, IT infrastructure and internal audit.

#### **Mission of European Investment Fund**

The purpose of EIF is to contribute to the pursuit of Community objectives (Article 2.1 of the EIF Statutes). In the context of its mission, EIF acquires participations in venture capital funds ("VCF") and issues guarantees. A third area of activity is the provision of advisory services to regional bodies, development organisations and the EC with a view to enhancing access to finance for SMEs.

In its transactions, EIF is regularly prepared to take the financial risk of its investments and guarantees.

EIF's investments and guarantees may be backed both by EIF's own resources and by various third party mandates ("Mandates"). At present, EIF manages the following Mandates:

- a. For venture capital investments:
  - the **Risk Capital Mandate** (comprising EIB's existing VCF portfolio before EIF's Reform in 2000) under a management agreement with EIB;
  - the **ETF Start-up Facility** ("ETF-SU") under a management agreement with the EC, acting in the name and on behalf of the European Community;
  - the **Seed Capital Action**, aiming at the long-term recruitment of additional investment managers by the venture capital funds under a management agreement with the EC, acting in the name and on behalf of the European Community; and
  - the **ERP-EIF Facility** under a management agreement with the German Ministry of Economics and Technology acting in the name and on behalf of the *ERP Sondervermögen*;
- b. For guarantees:
  - the **SME Guarantee Facility** under a management agreement with the EC, acting in the name and on behalf of the European Community.

## Management and Administration

Pursuant to Article 9 of its Statutes, EIF is managed and administered by

- its General Meeting
- its Board of Directors
- its Chief Executive

The shareholders of EIF shall, pursuant to Article 12.1 of the EIF Statutes, exercise their rights through the General Meeting. The General Meeting is empowered to decide on any amendments of the EIF Statutes and Rules of Procedure, to approve the annual financial statements and to appoint the members of the Audit Board.

In accordance with the Rules of Procedure, the General Meeting designates the members of the Board of Directors. The Board of Directors establishes the framework for the management of EIF and decides, in particular, on all operations of EIF.

In accordance with the Rules of Procedure, the Board of Directors appoints the Chief Executive of EIF. The Chief Executive is responsible for the on-going management of EIF pursuant to Article 16.1 (ix) of the EIF Statutes. The Board of Directors also submits the annual accounts and the annual report on the activities of EIF to the General Meeting.

## 2.2. Developments at EIF

### **Institutional**

Since the 2000 reform, EIF has developed its private shareholder basis. Various banks and financial institutions from EU Member States have acquired stakes in the capital of EIF. Banks and financial institutions from across the EU, including new EU Member States count amongst EIF's shareholders. Minority shareholders benefit from a put option guaranteed by EIB, which was renewed in June 2005. In 2005, several banks and financial institutions exercised the put option on their shares with the result that EIF's shareholding by banks and financial institutions decreased and EIB took these shares to increase its shareholding. At 31.12.2005, banks and financial institutions held 8.1% in the capital of EIF, EIB held 61.9% and the European Community held 30%.

### **Rating**

In 2005, EIF received a further AAA rating by Fitch, complemented by the AAA/Aaa ratings attributed to EIF by Standard & Poors and Moody's, respectively. EIF was first rated by these three ratings agencies in 2003 and was accorded the AAA/AAA/Aaa ratings in 2003 and 2004. As a consequence in 2004, the Basel Committee decided to permit national supervisors to apply a 0% risk weight to EIF under the New Basel Capital Accord and a 20% risk weight under the current Accord. This is particularly important to EIF's mission as the rating and the 0% risk weight under its MDB status increases the attractiveness of EIF's guarantees in the context of the Basel II<sup>1</sup> principles.

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<sup>1</sup> Also known as "The revised framework for international convergence of Capital Measurement and Capital Standards" (or "New Basel Capital Accord") – issued by the Basel Committee on Banking Supervision in June 2004

## **Community mandates**

The Community mandates under the Multi-annual Programme for Enterprise and Entrepreneurship, i.e. the SME Guarantee Facility, the ETF Start-up Facility and the Seed Capital Action, were extended by one further year, ending now on 31 December 2006.

For the budgetary period 2007 to 2013, the "Competitiveness and Innovation Framework Programme" 2007 to 2013 ("CIP Mandate") shall essentially continue the Community mandates managed by EIF under the MAP. Terms and conditions of the CIP Mandate are presently under discussion between EIF and the competent services of the European Commission.

The European Commission has furthermore launched the initiative "Joint European Resources for Micro to Medium Enterprises ("JEREMIE") as part of the 2007 – 2013 European Regional Development Fund (ERDF). In this context, in close co-operation with the EU Member States, EIF shall assess regional market failures in the financing of small and medium sized enterprises, including micro enterprises and make operational recommendations. JEREMIE shall enable EU Member States to profit from the specific know-how of EIF as the specialised Community institution for SME financing. On the basis of the joint assessment, EU Member States are invited to mandate EIF, for the budgetary period 2007 to 2013 with the management of (all or part) of the respective SME Access to Finance budget allocations under the European Regional Development Funds as regards SME financing.

The EIF Corporate Operational Plan (COP) 2006-2009 approved by the Board of Directors in January 2006 builds on the new elements above and sets new quantitative and qualitative objectives for this period.

## **Enhanced EIB Group co-operation**

In the context of the new strategic orientation for the EIB Group, the EIB Board of Governors confirmed the support of growth and employment within the European Union as the main task for the EIB Group. Facilitating the access to finance for small and medium sized enterprises shall, in particular, become one of the strategic priorities for EIB Group agreed by the Board of Governors in June 2005. It was consequently decided to reinforce the cooperation between EIB and EIF with a view to further strengthening the complementarities between both institutions. Part of that effort shall be the global relationship management approach, which should allow a systematic management of the client relationship both for EIB and EIF. A co-operation with regard

to the respective product policies, in particular as regards SME securitisation, the combination of guarantees and global loans and risk sharing loans shall be another element of a Group-related strategy.

### 3. AUDIT BOARD RESPONSIBILITIES AND ACTIVITY

#### 3.1. Responsibilities and tasks of the Audit Board

Pursuant to Article 22.1 of the EIF Statutes, the General Meeting appoints an Audit Board consisting of at least three, but not more than five, members. Pursuant to Article 20 of EIF's Rules of Procedure, the members of the Audit Board are appointed for three consecutive years and one member is replaced each year. There are currently three members of the Audit Board, appointed by the General Meeting, proposed by EIB, the European Community and the shareholding financial institutions.

Pursuant to Article 22.1 of the EIF Statutes, the Audit Board shall audit the accounts of EIF. In this context, pursuant to Article 22.2 of the EIF Statutes and Article 18<sup>2</sup> of EIF's Rules of Procedures, the Audit Board shall confirm by a written opinion whether to the best of its knowledge and judgement,

- the operations of EIF have been carried out in compliance with the formalities and procedures laid down in the EIF Statutes, EIF's Rules of Procedure and the guidelines and directives from time to time adopted by EIF's Board of Directors; and
- the balance sheet and profit and loss account of EIF give a true and fair view of the financial position of EIF as regards its assets and liabilities and of the result of its operations.

In agreement with Article 19<sup>3</sup> of EIF's Rules of Procedures "the Audit Board may have recourse to external auditors, which it shall designate after consultation with the Chief Executive and the Board of Directors. It may delegate the regular conduct of the audit of the Fund's financial statements to such designated external auditors. It may also, if necessary, collaborate with other experts".

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<sup>2</sup> As modified by the General Meeting of the Shareholders on May 2005 with a view to adapting the role of the EIF Audit Board to the role of the EIB Audit Committee

<sup>3</sup> As modified by the General Meeting of the Shareholders on May 2005 with a view to adapting the role of the EIF Audit Board to the role of the EIB Audit Committee

Therefore in carrying out its activities, the Audit Board does not itself conduct audit work. Instead, the Audit Board's core responsibilities are to:

- ensure a proper oversight, coordination and supervision of the work performed by internal and external auditors including adequate follow-up of audit recommendations;
- safeguard the independence and integrity of the audit function;
- understand and monitor how the Management of the Fund assesses the adequacy and effectiveness of internal controls, risk management and administration.

### 3.2. Review of Audit work performed in EIF

The work of the internal and external auditors' forms a key basis on which the Audit Board relies in the discharge of its responsibilities. It should be noted that the following bodies currently audit EIF:

- EIB Internal Audit in their capacity as Internal Auditors to the EIF, based on a contractual agreement dated 7 December 2000;
- External auditors in the context of the annual audit of financial statements, to date PricewaterhouseCoopers ("PwC") based on contractual agreement signed in March 2002.

Meetings are held between the external and internal auditors in order to ensure the efficient management of audit assignments and to avoid unnecessary duplication of audit work.

In addition, EIF has been or may also be audited in relation to its fiduciary activity by the following entities:

- Court of Auditors for EC Mandates;
- European Commission Internal Audit services for EC Mandates;
- External auditors in the context of the EC mandates.



The Court of Auditors has audit rights pertaining to its control of the EC holding in the EIF's capital within the framework of the Tripartite Agreement between EIF, the EC and Court of Auditors, signed in September 2001 and renewed in September 2003. The Tripartite Agreement expired on 25 September 2005; the renewal of its terms and conditions is presently under discussion between the parties.

Finally, EIB external auditors also intervene in the context of the consolidation with EIB.

### **External auditors**

The mission assigned to the external auditors (PwC) is to audit the annual financial statements of EIF in order to express an opinion on the true and fair view of the financial position and the results of EIF's operations.

The work performed by the external auditors is an important basis that allows the Audit Board to discharge its own responsibility in conformity with Article 22.1 referred above in 3.1. Therefore, the Audit Board attentively reviews the scope of the external auditor's work, examines the various reports produced and issued by them. The external auditors participated in most of the Audit Board meetings held in 2005.

The Audit Board reviewed the independence of the external auditors from EIF and its management. The Audit Board noted that, in 2005, the external auditors have not provided non-audit services to EIF, which are incompatible with their role as external auditors.

In 2005, Ernst and Young ("E&Y") completed an advisory mandate (as awarded in 2004) in order to assist EIF with a project related to the implementation of International Accounting Standards and International Financial Reporting Standards. The Audit Board received assurances from Management and from E&Y that the work did not pose an independence threat to E&Y's mandate as external auditors of the EIB Group.

### **Internal Audit**

Following the 2000 reform, an Internal Audit function was established at EIF. The audit programme issued by the Internal Audit focuses on the activities and specific tasks undertaken by EIF and aims to achieve an appropriate audit coverage over a three to five year cycle.

The Audit Board approved the draft Internal Audit work programme for 2004-2006, including the Internal Control Framework ("ICF"), and the detailed final programme for 2005.

During Audit Board meetings audit reports produced in 2005 and other matters of importance were discussed with the Inspector General or the Deputy Head of Internal Audit.

Recommendations from internal and external auditors form part of agreed action plans with target dates that are agreed and implemented by EIF Management. On the basis of the bi-annual reports of Internal Audit, the Board has reviewed the status of audit recommendations. The Audit Board appreciates the efforts dedicated by EIF Management in response to the findings of internal and external auditors. The Audit Board encourages EIF Management to respond as promptly as possible to Audit recommendations whilst taking into account any external constraints that might impact the target dates.

The internal audit annual activity report and the ICF for year-end 2005 became available in January 2006 and have been taken into consideration in preparing the present report.

The principal objectives of the Risk Control Matrix included in the ICF are to:

- identify the key risks relating to the business activities undertaken by EIF;
- 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 Board has sought and received assurance from Management (representation letters) that the ICF mitigates against operational risks in all significant activities and that the ICF has been updated according to changes in business activities and as new application systems are implemented.

### **European Court of Auditors**

In 2004/2005, the European Court of Auditors performed an audit of the participation of the European Community in the capital of EIF and the Audit Board has

reviewed its last annual report<sup>4</sup>. The Audit Board notes that a specific concern expressed in relation to compliance of EIF's business activities with Community policies was considered by EIF in 2005 within the implementation of the compliance function referred below in point 3.3.3.

### 3.3 Review of significant actions taken by EIF and further developments

Significant measures have been taken by EIF to respond to the recommendations raised in the Audit Board's 2004 annual report, to the changing business environment and to manage the risks arising from its activities. Key measures are summarised below.

#### 3.3.1 The application of International Accounting Standards and International Financial Reporting Standards

As anticipated in the 2004 annual activity report of the Audit Board, the implementation of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) has been a significant challenge for the EIF during 2005.

The IAS/IFRS compliance for 2005 was required mainly for Group reporting as the EIF was to report its 2005 consolidated figures under IAS/IFRS. The EC also had similar new reporting requirements as far as the fiduciary mandates managed by EIF are concerned.

EIF will produce IAS/IFRS-compliant stand-alone financial statements for the year ended 31st December 2006.

In 2005, the Board considered the impact of the application of relevant IAS and IFRS on EIF's financial reporting processes. The Board also noted that a number of new and revised standards emerged in 2005 for which there is limited implementation experience, even at an international level. In particular, the Audit Board notes the lack of international agreement on precise valuation/accounting methodologies for venture capital fund-of-fund activities as a key issue impacting on EIF. The Board is conscious that the IAS/IFRS accounting process will mature and settle over time, and that the growing experience of the industry as the whole may lead to further changes in the future.

The Board notes that the application of IAS/IFRS to EIF's standalone financial statements for the year ended 31st December 2006 will require a continued significant

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<sup>4</sup> Annual report concerning the financial year 2004, OJEU 2005/C 301/01 dated 30 November 2005

involvement from all EIF services and auditors. As changes in accounting policies often create fluctuations in the financial results, communications with interested parties, including shareholders, will also need to be suitably managed. The Audit Board therefore reiterates its 2004 recommendation that a formal IAS/IFRS project should be supported and monitored by the Chief Executive. The Audit Board commits to monitoring management progress in this area.

### 3.3.2 Risk management and the monitoring of Venture Capital Fund (VCF) and of Guarantees

An independent risk management function was established in 2001, reporting directly to the Chief Executive. Progressively, the risk management capabilities have been strengthened and activities now cover a broad scope of the Fund's activities. To date, the risk management area has been responsible for the IT systems at EIF. However, an IT unit has now been established within the EIF's Secretariat General, in line with Audit Board recommendations.

In 2005, EIF's Risk Management department introduced a new IT system and associated procedures were implemented to improve monitoring of VCF and a similar re-engineering project is on-going to support enhanced monitoring of guarantees. A Valuation Committee has been established to oversee the application of the new valuation procedures triggered by the implementation of IAS/IFRS which have led to increased levels of information and associated monitoring requirements. The Audit Board recognises the complexity of the project and additional workload involved and supports the positive actions being taken by EIF management.

The Audit Board believes that the IT and monitoring improvements will ensure timely and improved reporting information which is essential to the decision makers, notably the Board of Directors and the Shareholders.

Finally the Audit Board will continue to closely monitor the developments in risk management and to seek assurance from management and the auditors that internal controls are being adapted in a timely manner in response to the changing business environment and, in particular, to manage any emerging risks which may impact on the role or responsibilities of the Audit Board.

### 3.3.3 Compliance function

The Audit Board considers that it is part of its mandate to review the effectiveness of the Fund's system for monitoring compliance with relevant laws and regulations (including

internal rules) and the measures taken by Management as a result of its investigation of material incidents of non-compliance.

The Audit Board welcomes the actions taken in 2005 by the Chief Executive, supported by the Board of Directors, to implement the compliance function as recommended in the Audit Board's 2004 annual activity report.

During 2005, the nominated compliance officer has been working on the preparation of a compliance charter and a compliance procedure. These documents have been submitted to the Board of Directors and signed in January 2006 by the Chief Executive. The Compliance Charter details the position of the EIF Compliance Function within the corporate structure and the Compliance Procedure describes the intervention of the EIF Compliance Function within the internal procedures of EIF as well as its interaction with other services in EIF. In addition to the usual tasks of a compliance function, the EIF Compliance Function also identifies, assesses and monitors compliance with European Community policies.

The EIF Compliance Function maintains regular contacts with the EIB Group Chief Compliance Officer and also with the competent Commission services on the identification of Community Policies applicable to EIF's business.

On the basis of the compliance standards and areas of risks considered in the Compliance Charter, the Board anticipates it will derive assurance from the EIF Compliance Function on matters such as the regulatory framework and risk management as applicable to EIF. The EIF Compliance Function should also provide an increased assurance for the management of fiduciary mandates, notably for the EC, where compliance with Community policies and regulations is essential.

The Audit Board will also seek assurance from the EIF management that the necessary independence and resources of this compliance function is being maintained and that the function is paying sufficient attention to the specific circumstances of EIF. As this is a new function, the Audit Board is of the view that the first 2006 annual activity report of the Compliance Function should be an opportunity to assess the effectiveness of the Compliance Function according to international standards.

#### 3.3.4 Corporate Governance

In 2004, the Audit Board underlined the attention it pays to corporate governance. The Board recommended that EIF, with its position at the forefront of the investment industry and with its status as an EU financial institution, should lead the adoption of good

corporate governance practices in a pragmatic manner in order to reinforce the drive for integrity, independence, transparency and accountability at every level of the organisation.

Therefore the Audit Board welcomes the steps taken by EIF in 2005 with the creation of the compliance function and also the publication of a Statement of Governance and a Statement on Corporate Social Responsibility.

In 2005, the Audit Board has also reviewed its own governance arrangements<sup>5</sup>. The Board has:

- assessed its own performance against industry-accepted good practices for audit committees in order to identify improvements made and key areas where its activity needs to be formalised or strengthened;
- started a review of its own organisational and procedural practices; and
- established the need for an Audit Board Charter, which has been drafted.

The review has not been finalised to date due to the difficulties experienced so far in recruiting a part-time Advisor to the Audit Board. Hopefully this issue will be resolved during 2006 if the recruitment is finalised.

In order to ensure that its organisation and procedures are strengthened, the Audit Board has met more frequently during 2005. The individual members dedicated also separate preparatory time in order to ensure that the Audit Board collectively had sufficient time in which to fulfil its statutory duties.

The Audit Board recognises that effective corporate oversight can enhance financial performance and alignment with shareholders' interests. The further development and strengthening of the corporate governance and oversight provided by, and through the work of, the Audit Board will take into consideration the relative size of EIF and its responsibilities and obligations as an EU financial institution. However, for the reasons set out above further developments will depend on the availability of a permanent Advisor to the Audit Board in 2006 and beyond.

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<sup>5</sup> With the interim assistance of the Advisor to the EIB Audit Committee, which was provided within the terms of an agreement between the EIF and the EIB and which was pre-approved by the Audit Board.

#### 4. CONCLUSION

In 2005, the Audit Board is satisfied that EIF has taken the necessary measures to respond to the recommendations raised in the Audit Board's 2004 report, to the changing business environment and to manage the risks arising from its activities.

This was notably the case for the coordinated efforts and investments made to respond to the challenge of implementing the IAS/IFRS standards, which provides an opportunity to further strengthen the organisation's procedures and control in monitoring the two main business activities, Venture Capital and Guarantee.

The establishment a Compliance Function too shall be a strong new element of the EIF internal control process, providing an increased assurance of compliance with Community policies and regulations as far as EC fiduciary mandates is concerned.

The Audit Board also welcomes the enhanced EIB Group co-operation which will increase synergies in the framework of the new strategic priority for SME's in EIB Group.

As announced in 2004, the Audit Board has also started reviewing its own governance arrangements, assessing its own performance against accepted good practices for audit committees and examining its own organisational and procedural practices. Completion of the review and further such developments will depend on the availability of a permanent Advisor to the Audit Board in 2006 and beyond.

In the coming year, in respect of the key issues identified in this report, the Audit Board can summarise that it will place particular emphasis on:

- The establishment of IAS/IFRS-compliant standalone financial statements for the year ended 31st December 2006. Taking into account the particular environment described in this report, notably for the venture capital valuation/accounting, the Audit Board reiterates its recommendation from 2004, that a formal IAS/IFRS project should be supported and monitored by the Chief Executive. The Audit Board commits to monitoring management progress in this area.

- The solid development of the Compliance Function. The Audit Board will seek assurance from the EIF management that the necessary independence and resources of this Compliance Function is being maintained and that the function is paying sufficient attention to the specific circumstances of the EIF. As this is a new function, the Audit Board is of the view that the first 2006 annual activity report of the Compliance

Function should be an opportunity to assess the effectiveness of the Compliance Function according to international standards.

Overall and in the positive perspective of new mandates and financial reinforcement of the EIF structure, the Audit Board will continue to provide further insight for the formalisation and improvement of audit, risk management and corporate governance issues at EIF following industry best practice and standards while taking into account the specific nature of EIF and the EIB Group.

Echternach on 2 May 2006

S. Simonetti, Chairman

H. Lipponen, Member

R. Poveda Anadón, Member