



AUDIT BOARD

ACTIVITY REPORT TO THE

GENERAL SHAREHOLDERS' ANNUAL MEETING

FOR THE 2004 FINANCIAL YEAR

1. INTRODUCTION	1
2. THE EUROPEAN INVESTMENT FUND: MISSION AND MILESTONE DEVELOPMENTS	1
2.1. Background	1
2.2. Milestone developments	3
3. AUDIT BOARD RESPONSIBILITIES AND ACTIVITY	4
3.1. Responsibilities and tasks of the Audit Board	4
3.2. Review of Audit work performed in the EIF	5
3.3. Review of significant actions taken by the EIF and further developments	7
4. CONCLUSION	10

1. INTRODUCTION

Following the request by the European Investment Fund ("EIF" or "Fund") Shareholders' Meeting dated 11 November 2004 the Audit Board reacted to issue a first Annual Activity Report providing an overview of the activities of the EIF Audit Board during the past year. The activity report was prepared expressly for use by the Shareholders' General Annual Meeting and is based on the analysis of information available at the time of its preparation. Statements in this report relate to the compliance of EIF's operations in 2004 with its Statutes and Rules of Procedure as well as its internal policies and guidelines. The present report also discusses the following main topics: the International Financial Reporting Standards ("IFRS"), the monitoring of venture capital and guarantees, corporate governance and risk management.

2. THE EUROPEAN INVESTMENT FUND: MISSION AND MILESTONE DEVELOPMENTS

2.1. Background

The European Investment Fund

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

In June 2000, the General Meeting decided to re-define the business focus of the EIF. As a consequence, EIF is positioned as the EU 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 both with a mission to facilitate the access to finance for (SMEs).

The 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 with a view of being performed on a group level; this applied, in particular, with regard to HR administration, IT infrastructure and the internal audit.

Mission of the 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"), issues guarantees, and, to a lesser extent provides advisory services with a view to enhance access to financing for SMEs. In its transactions, EIF is regularly prepared to take the final 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 (incorporating EIB's existing VC portfolio before the Reform) under a management agreement with EIB;
- the European Technology Fund ("ETF") Start-up Facility under a management agreement with the European Commission 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 European Commission 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 Economy and Labour acting in the name and on behalf of the *ERP Sondervermögen*;

b. For guarantees:

- The SME Guarantee Facility under a management agreement with the European Commission ("EC") acting in the name and on behalf of the European Community.

Management and Administration

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

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

The shareholders of the EIF shall, pursuant to Article 12.1 of the EIF Statutes, exercise their rights through the General Meeting. The General Meeting is, in particular, 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.

The General Meeting, acting in accordance with the Rules of Procedure, 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.

The Board of Directors appoints, in accordance with the Rules of Procedure, the Chief Executive of the 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.

Audit Board

According to Article 22 of the EIF Statutes, the annual accounts of EIF are audited by the Audit Board whose role is described in more detail hereafter under § 4.1.

2.2. Milestone developments

Institutional

Since the 2000 reform, the EIF has further developed its private shareholder basis. Various banks and financial institutions from all EU Member States, such as Vaekstfonden from Denmark, Banque et Caisse d'Epargne de l'Etat BCEE (Luxembourg), San Paolo IMI (Italy), Stiftelsen Industrifonden (Sweden), but increasingly also institutions from new EU Member States, such as Bank of Valetta plc. (Malta), Hungarian Development Bank (Hungary) and from accession countries, such as Encouragement Bank (Bulgaria), have since acquired stakes in the capital of EIF; as a result, the private institutions presently hold as much as 10.85% in the capital of EIF together with 59.15% for EIB and 30% for the European Community.

Rating

In 2004 the EIF received an AAA rating by Fitch, a fact that complemented the AAA/Aaa rating that was attributed to EIF in 2003 and in 2004 by Standard & Poors and Moody's, respectively. This plays a particularly important role in the context of the mission of EIF. This role will further enhance the EIF guarantee activities in the light of the up-coming introduction of the Basel II principles. Moreover, in 2004 the Basel Committee decided to permit national supervisors to apply a 0% risk weight to the EIF under the New Basel Capital Accord and a 20% risk weight under the current Accord.

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. Currently, three members of the Audit Board are appointed by the General Meeting in compliance with the provisions of Article 22 of the EIF Statutes and Article 20 of EIF's Rules of Procedures, following proposals made by the three groups of Shareholders (the European Investment Bank, the European Community and the Financial Institutions.)

The Audit Board shall, pursuant to Article 22.1 of the EIF Statutes, audit the accounts of the EIF. In this context, the Audit Board shall, pursuant to Article 22. 2 of the EIF Statutes and Article 18 of EIF's Rules of Procedures, confirm by a written opinion whether

- 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 in respect of its assets and liabilities and of the result of its operations.

In agreement with Article 19 of EIF's Rules of Procedures “ the Audit Board shall also have recourse to, and be provided with audit reports of the Accounts of the Fund drawn up by independent accountants which it shall appoint after consultation with the Chief Executive and the Board of Directors. It may also, if necessary, collaborate with other experts.”

In carrying out its activities, the Audit Board does not itself conduct audit work. Instead, the Audit Board believes that its core responsibilities are to ensure a proper oversight, coordination and supervision of the work performed by internal and external auditors, to maintain the independence and integrity of the audit function, to ensure that there is an adequate follow up of audit recommendations and to monitor how the Management of the Fund is assessing the adequacy and effectiveness of internal controls, risk management and administration.

3.2. Review of Audit work performed in the EIF

In conformity with Article 19 of EIF's Rules of Procedures, internal and external auditors' work is the cornerstone on which the Audit Board relies to make up its opinion and discharge its responsibility. It should be noted that the EIF is currently audited by the following bodies:

- 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 the EIF has been or might 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;
- EIB external auditors in the context of consolidation with EIB;
- External auditors in the context of the EC mandates.

It is finally worth mentioning the audit rights of the Court of Auditors pertaining to its control of the EC holding in the EIF's capital within the framework of the tripartite agreement between the EIF, the EU Commission and Court of Auditors signed on 25 September 2001 and renewed in September 2003.

External auditors

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

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 reviewed with great attention the scope of the external auditor's work, examined the various reports produced and issued by them. During Audit Board meetings or private meetings, matters of importance were discussed with the external auditors. The external auditors attend all Audit Board meetings.

The Audit Board reviewed the independence of the external auditors from the EIF and its management. The Audit Board also noted that the external auditors have not provided non-audit services to the EIF in 2004.

Internal Audit

Following the 2000 reform an Internal Audit function was established. The audit programs issued by the Internal Audit were focused on the activities and specific tasks undertaken by the EIF and achieved coverage over a three to five year cycle.

The Audit Board meets with the head and/or deputy head of Internal Audit at each Audit Board meeting. The Audit Board was consulted on the drafting of the Internal Audit (including Internal Control Framework ("ICF")) work program for 2004-2005. In order to ensure full coverage, the program includes an analysis of audit activity in the last three years and a risk matrix.

The Audit Board took note of the Internal Audit reports produced in 2004, focusing on those covering financial and operations risks, as well as administrative aspects. The most important of these were reviewed and discussed in detail.

The Board also monitored the implementation of internal and external audit recommendations, in particular on the basis of the bi-annual reports on the status of Audit Recommendations as at 31 December 2003 and as at June 2004 produced by the Internal Audit. It has been noted that agreed action plans exist for all recommendations that remained outstanding as of year-end 2004. Overall, the Audit Board takes note of the progress that has been accomplished in response to internal and external audit recommendations and encourages the EIF management to respond more promptly to Audit recommendations.

At the time of preparing our Annual Activity Report, reports on the Internal Control Framework (ICF) for year-end 2004 became available. 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 the EIF;
- Identify and review, at a macro level, the internal control processes implemented to ensure that risks are mitigated and/or minimized to an acceptable level.

The Board considers the ICF, in place since 2002, to be very useful for the EIF in providing an improved level of assurance as to the efficiency and effectiveness of the internal controls for the EIF's main operational areas. The requested and implemented integration of the main procedures in the 2004 year end ICF matrix is a welcomed improvement.

The Board will continue to closely monitor further enhancements of ICFs and will seek assurance that ICF's are updated on a timely basis according to significant changes impacting the activity of EIF. Moreover, it will also ensure that the Internal Audit work program is being executed and that audit resources are maintained at a level necessary to do so.

3.3. Review of significant actions taken by the EIF and further developments

The Audit Board considers that significant actions have been taken by the EIF to respond to the changing environment and to manage the risks arising from trends in its activities but further efforts are still needed.

The key measures examined below include the application of International Financial Reporting Standards (IFRS) and the related valuation problematic, the monitoring of Venture Capital Funds and Guarantees, the formalisation and update of procedures. In addition further developments in corporate governance and risk management are also examined.

3.3.1 The application of International Financial Reporting Standards (IFRS) and related valuation problematic

IFRS are being adopted by many companies around the world. All listed companies that prepare consolidated accounts in the EU are required to apply IFRS by 2005. The Audit Board stressed the importance of adopting IFRS in 2005 in consideration primarily of this global trend and indirectly of the reporting requirements of the majority shareholder, the EIB, and of the European Commission in relation to the EC mandates with the EIF.

Consequently and in response to Audit Board encouragements to address all IFRS issues, the Management of EIF has appointed Ernst and Young ("E&Y") to ensure a proper

conversion to IFRS. The initial work consisted of a gap analysis whereby E&Y prepared a detailed report on the current situation of the Fund and an action plan to bring EIF in compliance with IFRS. The resulting action plan outlined three consecutive phases.

A preliminary analysis of challenges related to the adoption of IFRS indicated that they will pose significant difficulties both to the venture capital and guarantees business lines. This is due to the unique nature of the EIF's activities whereby little industry support is anticipated. More specifically, the adoption of IFRS raises the issue of "fair" valuation of VCFs given the fund of funds nature of operations and also raises the issue of categorization of guarantees resulting in a different valuation methodology depending on the rules (IAS 39 or 37) that are followed.

EIF has developed a new valuation methodology for venture capital fund operations. E&Y will comment on the appropriateness of the proposed EIF valuation methodology to achieve IFRS compliance. The retained valuation methodology will need to be approved by the Management of the EIF, after there is consensus from the Audit Board. Since the new valuation methodology for venture capital funds has not yet been approved by all concerned parties and the European Venture Capital Association ("EVCA") has not yet issued guidelines for direct investments, the existing valuation methodology, whereby EIF's venture capital investments are evaluated at the lower cost or attributable net asset value, has been applied to all venture capital investments as of year end 2004.

The Audit Board believes that the IFRS conversion process and related valuation problematic constitute a main challenge facing the EIF in 2005 and will therefore require a regular and close monitoring by the Board of Directors, the Audit Board and the Chief Executive.

3.3.2 Monitoring of VCF and of Guarantees

Significant efforts were made by the EIF's risk management to improve the monitoring of VCF and of guarantees subsequent to the recommendations issued by the internal and external auditors.

The implementation in 2004 of e-Front, a dedicated front-to-back office IT system, improved the monitoring of VCF significantly and automated certain control and monitoring functions between the front and back office. By means of this system, the information on a specific fund is available simultaneously to any area of the EIF. Furthermore, e-Front introduced an outsourced application where access control is built into the product and EIF staff have no development responsibilities. Likewise, EIF has developed a system in-house to monitor guarantees. A new project that will cover the entire workflow of guarantees in a similar way to the e-Front application for VCF has been started recently.

EIF has implemented a rating system based on established methodologies used by rating agencies to assess the risk of its guarantees. Risk management validates the model used to rate a transaction and verifies the validity of the underlying assumptions.

For venture capital EIF has implemented a grading system covering performance, compliance and operational aspects of the VCFs. In the case of VCFs the Operations department assigns the grades, and Risk Management validates the grading proposed through a scoring methodology.

With the implementation in 2005 of a fair value valuation method compliant with IFRS regulations, the monitoring of the VCF and guarantees will have a more vital task ahead and a series of new measures will be required in order to ensure a smooth transition to the new valuation methodology.

Due to the nature of the EIF's main activities with major implications in risk assessment and valuation, the Audit Board believes that the formalisation of a project management procedure on modelling and valuation issues could be useful in this particular sensitive transition process.

3.3.3 Increased formalisation and update of procedures

Significant efforts were made over time by the EIF in order to have the procedures formalized and available to all staff members. The Audit board considers that the process of consolidating and updating the procedures following the different recommendations/directives and Board of Directors' decisions applicable to the Fund should be further strengthened. It is also important to ensure a systematic application of these procedures by all staff members.

The Audit Board believes that the creation of a compliance function could significantly enhance corporate governance in that field and would be in line with recently accepted best practices.

3.3.4 Corporate Governance

The Audit Board believes that the heightened international attention to corporate governance and its quasi EU institutional status place the EIF at the forefront of the investment industry. It believes therefore it has an obligation to lead by example by reinforcing integrity, independence, transparency and accountability at every level of the organisation. Therefore the Audit Board has decided to conduct a review of its role and methods of operating.

In light of the sensitive and confidential information in relation to the particular business of the EIF, the Audit Board has already adopted a code of conduct defining rules and principles that apply to all members of the Audit Board. The Audit Board will strengthen its own procedures with respect to meetings and discussions involving members of the Management of the Fund. The Audit Board will examine the need of adopting an Audit Board Charter, which could be a component of a flexible framework within which the Board intends to conduct its affairs. In order to succeed in the strengthening of its organisation and procedures, the Audit Board will require first to meet more frequently and secondly to benefit from the permanent assistance from an experienced professional in the discharge of its responsibilities. The Audit Board plans to build on the experience gained by the EIB in this matter. The Audit Board does not exclude that the review of corporate governance practices may lead to proposals for changes in the Rules of Procedures to be presented to a future shareholders general meeting.

In its efforts to strengthen corporate governance, the Audit Board recognizes that effective corporate oversight will enhance financial performance and alignment with shareholders' interests. The further development and strengthening of corporate governance will be achieved taking into consideration the relative size of the organization and its responsibilities and obligations as a quasi EU institution.

3.3.5 Risk management

Following the reform of EIF in 2000, an independent risk management function was established reporting directly to the Chief Executive Officer. Progressively, the risk management capabilities were strengthened and its activities have expanded covering a relative broad scope of Fund's activities.

Moreover, the implementation of the IT/Database system e-Front is expected not only to provide a comprehensive database but also to strengthen implied control mechanics in the venture capital operations area. An additional system development is undertaken for the guarantee operations area as well.

Considering the crucial importance of this function for EIF internal control systems the Audit Board encourages management to continuously adopt best risk management practices in a rapidly changing environment. The Audit Board will continue to monitor closely the developments in the risk management area.

4. CONCLUSION

It is the Audit Board's unanimous opinion that the EIF is conducting its affairs in accordance with its Statutes and Rules of Procedures. The Audit Board recognises the

significant measures taken by the EIF's management to maintain and improve control awareness and responsiveness given the limited size of the organization. However improvements in the areas of a systematic consolidation/review of procedures and a timelier follow up of recommendations are expected.

The adoption of IFRS by EIF in 2005 raises specific challenges for the venture capital and guarantees business lines. The IFRS conversion process will therefore require a regular and close monitoring by the Board of Directors, the Audit Board and the Chief Executive during this year.

The "fair" valuation of venture capital and guarantee operations is perceived as the most significant issue facing the Fund. Valuation and monitoring of venture capital operations have been improved in anticipation of the adoption of IFRS. However, further improvements, especially in the area of validation of risk assessment and valuation methodologies are expected. The Audit Board believes that the formalisation of a project management procedure could be useful in this sensitive transition process.

Finally the Audit Board believes that the heightened international attention to corporate governance and its quasi EU institutional status place the EIF at the forefront of the investment industry. The creation of a compliance function could significantly enhance corporate governance within the Fund. On its part, the Audit Board is prepared to launch a review of its role and methods of operating to further strengthen its organisation and procedures.

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 the EIF and the EIB group.

Date, 15th March 2005

M. Haralabidis, Chairman

S. Simonetti, Member

H. Lipponen, Member