GENERAL MEETING

Annual Activity Report of the EIF Audit Board for the 2016 financial year

For information

To be treated as confidential information
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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 2016/2017 (since the AGM in April 2016 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 2016.
- The Internal Audit reports issued in 2016 and up to March 2017 including the 2016 Internal Audit Annual Activity report.
- The 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 low, except for the EIF Compliance function where the risk has been assessed as high. 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 2016 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 formally assesses whether this is the case, taking into account the work it has performed during the year, the foregoing sources of assurance and also relying 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 2016.
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 adopted by EIF management. The Audit Board notes that the actual closing rate was 69% at 31 December 2016 which met the target of 60%. This confirms the continued priority placed on the closure of AAPs by Management. The Audit Board notes that only one AAP issued prior to 2016, reported as part of the EIF Co-investment with Business Angels audit (issued in the fourth quarter of 2015), is still outstanding at year-end. There are 60 outstanding AAPs at year-end. The bulk of new AAPs (10 high, 34 medium and 4 low risk) were originated in the EIF Compliance function audit report issued on 21 December 2016. EIF was already able to close 3 of those AAPs (1 high and 2 medium risk) during the audit. The remaining newly issued AAPs (7 medium and 10 low risk) resulted mainly from the EIF Third Party Treasury audit report issued on 20 October 2016, where EIF already implemented 71% of AAPs (5 medium and 7 low risk) by year-end.

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 2016 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 2016 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.

AUDIT BOARD CONCLUSIONS FOR 2016 AND AREAS OF FOCUS FOR 2017

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 2016, 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 2017:

- Oversight of the continued evolution of risk management, internal control and assurance and audit mechanisms;
- Enhancing cooperation between EIB Audit Committee and EIF Audit Board;
- Monitoring the future development of the ISAE 3402 reporting process (as described in section 5);
- Progress in the implementation of AAPs, with special attention given to the 2016 Compliance audit 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 2016 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. Paolo Pernice, as a member of the Audit Board on 11 April 2016. Mr. Pernice, Chief Financial Officer at Intesa Sanpaolo Bank Luxembourg, has been nominated to the Audit Board by the Financial Institutions following completion of the term of office of Mr. Borg.

The other members are: Mr. Dries, Deputy Head of Unit European Commission, DG IAS.C; Mr. Dominik, General Counsellor at the Ministry of Finance in Poland, 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 2016, the statement of comprehensive income, statement of changes in equity, cash flow statement for 2016, 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 2016, 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 appropriate. 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 2016 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 Internal Audit Department. Internal Audit covers the significant activities and specific tasks undertaken by EIF on a risk-based three year cycle. In November 2016, the Audit Board approved the Internal Audit rolling work programme for the period 2017–2019.

4.2.1 Internal Audit Reports and Assessment of Internal Audit Work

The Internal Audit Annual Activity Report was made available in February 2017 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 2016, with the corresponding reports being finalised, received and discussed with the Audit Board during the year 2016. One assignment on the EIF Capital Allocation was on-going at 31 December 2016 with the report being issued in February 2017. 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 three 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 2016 QAR. Minor areas of improvement were identified mainly in relation to the enhancement or update of Internal Audit documentation. The Audit Board recognises the continued commitment of Internal Audit to reaching the highest professional standards in its work.
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 of closing at least 60% of Agreed Action Plans (AAPs) contained in Internal Audit reports issued in the previous two years has been adopted by EIF management. From the review as at 31 December 2016 the Audit Board notes EIF’s implementation performance of AAPs of 69%, which surpasses the target of 60%. This confirms the continued priority placed on the closure of AAPs by Management. There are 60 outstanding APPs at year end. The bulk of new AAPs (10 high, 34 medium and 4 low risk) were originated in the EIF Compliance function audit issued on 21 December 2016 and which is discussed further in Section 6 of this report. EIF was already able to close 3 AAPs (1 high and 2 medium risk) during the audit. The remaining newly issued AAPs (7 medium and 10 low risk) resulted mainly from the EIF Third Party Treasury audit report issued on 20 October 2016, where EIF already implemented 71% of AAPs (5 medium and 7 low risk) by year-end.

Three AAPs, all of them medium risk and due by 31 December 2016, became overdue at year-end. Two of them are related to the EIF secondary market sale transaction audit report (issued in 13 July 2016). Both points are delayed waiting for the next eFront release scheduled on 30 June 2017. They respectively concern the monitoring of counterparty credit risk and the implementation of a General Ledger Accounting Hub. The third medium risk overdue AAP is linked to the specific mechanisms to ensure that applicable AML KYC principles are adhered to as part of the European Angels Fund investment product (audit issued on 15 October 2015). The control will be implemented by end of the third quarter of 2017 together with the general update of all Compliance procedures.

The 7 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 November 2016, the Evaluation Division (which is under the responsibility of the Inspector General) presented the work of the division to the Audit Board. The division informed the Audit Board about the mid-term evaluation of the European Fund for Strategic Investments (EFSI), which was required by the EFSI regulation. The objective of the evaluation was to assess the functioning of EFSI, i.e. how resources were used and which activities were undertaken and to what extent these were conducive to achieving EFSI’s objectives. The key conclusion of the evaluation was the fast implementation of EFSI by EIF under the SMEW due to the frontloading of products under existing mandates. Frontloading also contributed to
additionality as finance became available faster and with a broader outreach to SMEs and small midcaps than otherwise would have been the case.

5. **INTERNAL CONTROL FRAMEWORK AND OTHER ADDITIONAL ASSURANCE**

The Internal Control Framework (ICF) exercise reflects the results of the risk self-assessment exercise which translates 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.

In line with established practice, the Audit Board has sought and received assurances from the Chief Executive by way of a representation letter in relation to internal control. The CEO has acknowledged his responsibility for establishing and maintaining an internal control structure covering the EIF’s business activity which provides reasonable assurance on an ongoing basis that:

(i) key risks are properly identified,

(ii) control objectives have been defined to ensure that significant risks are managed and that EIF business activities are carried out in compliance with the formalities and procedures laid down by the Statutes and the Rules of Procedure, and

(iii) controls designed to achieve these objectives are in place and are, to the best of his knowledge, operating effectively.

The Audit Board has been assured in this letter from the Chief Executive that the internal control structure as described in the risk control matrix is adequate to achieve these objectives and, to the best of his knowledge, was in place and operated effectively during the year, except for matters described as agreed improvements in the matrix or in internal audit reports.

On 14 February 2017, 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 low, except for the Compliance function where the risk has been assessed as high. 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 governs 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.

In 2016, EIF, under the coordination of the Corporate Risk Management Division, mandated Deloitte to examine EIF’s description of its Mandate Management Services (related to Equity, Guarantee, Securitisation & Microfinance Products) system for processing mandators’ transactions as at 31 December 2016 and the suitability of the design of controls to achieve the related control objectives stated in the related ISAE-3402 Type 1 report. In that context, the Audit Board has received assurance from Deloitte in a letter dated 14 February 2017 that, in their opinion, in all material respects, based on the criteria described in EIF’s assertion in the report, (i) the description fairly presents the system related to Mandate
Management Services related to Equity, Guarantee, Securitisation & Microfinance Products activities that was designed and implemented as at 31 December 2016; and (ii) the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as at 31 December 2016, and mandators applied the complementary mandator controls contemplated in the design of EIF’s controls as at 31 December 2016.

Throughout the year, the Audit Board obtained assurance about 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. In addition, the Audit Board also formally assessed the effectiveness of the EIF’s internal control and risk management systems. This assessment process is based on the guidance contained in Guidance on Risk Management, Internal Control and Related Financial and Business Reporting published by the Financial Reporting Council.

6. **RISK MANAGEMENT**

**Department Organisation**

Since the reorganisation of EIF’s second line of defence in 2015 credit and equity risk management, operational risk and compliance are integrated in EIF into a single risk management department.

Subsequently, Credit and Equity Risk Management Divisions were integrated, which should reinforce the comprehensive assessment of the financial risk in EIF operations and reflect the growing convergence of credit and equity-type financial risks. Hence, from 1 February 2017 on, the new department consists of three divisions: the Corporate Risk Management Division, the Compliance Division, and the Operations Risk Management Division.

**Operations and Mandates**

The unprecedented increase in the volume of operations created a heavy workload for the department, in particular, as regards the issue of independent opinions, which increased by one third between 2015 and 2016. The restructuring of the Credit and Equity Risk Management Divisions into the Operations Risk Management Division is expected to allow efficiency gains, which, together with additional recruitments in 2016 and 2017 should allow the expected increase in business volumes to be addressed.

A specific focus is the management of mandate related risks in view of the steep increase in the number of mandates -up to over 90 mandates at the end of 2016-. Risk Management has elaborated on a matrix of the different mandate characteristics and started to develop a risk assessment and surveillance process within a specialist mandate risk management allocation. Mandate Risk Management was identified to be closely linked to the risk of deficiencies in internal processes. Assessment and surveillance of EIF mandate risk will therefore be built upon an extension of the EIF Internal Control Framework in consideration of any specific processes or requirements of individual mandates.

**Operational Risk**

A key achievement in the context of operational risk was the testing of the EIF Internal Control Framework against the ISAE 3402 standard. This comprised a testing of design. The testing of the effectiveness may constitute a second phase to be pursued in the course of 2017.
Compliance

An audit on the EIF Compliance function was undertaken during the latter part of 2016. The principal objective of this audit was to evaluate the design and effectiveness of the existing control environment in mitigating key business risks associated with EIF’s Compliance function. The audit report was issued in December 2016, and its outcomes were presented to the Audit Board in February 2017.

The work of the Compliance Division provides key assurance to the Audit Board that supports one of the opinions which the Audit Board, in turn, is required to provide to the general meeting namely, that to the best of its knowledge and judgement, the operations of the EIF have been carried out in compliance with the formalities and procedures laid down in the Statutes and the Rules of Procedure. The expansion of the EIF’s business over the last two years plus the increasing complexity of some of the issues that require to be examined by the Compliance Division, such as tax transparency, have undoubtedly presented a big challenge to that Division. This was recognised by the Internal Audit report which noted that the Compliance Division is currently in a transition phase and that staffing levels had only relatively recently been increased (from two at the end of 2015 to six at the end of 2016 with a further four planned).

In this context, the Audit Board considers the Internal Audit report to be timely and that the AAPs contained therein provide a strong basis for building a Compliance function and a corporate culture that demonstrably meet the high standards that stakeholders should expect. In saying this, the Audit Board notes that compliance is not a matter solely for the Compliance function and that “buy-in” from other services and, indeed, full and healthy co-operation at Group level will also be necessary. For this reason, the Audit Board welcomes the commitment of the Chief Executive and the Deputy Chief Executive to make Compliance a priority following the Internal Audit report. The Audit Board will continue to monitor progress in this area throughout 2017.

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 2016.

8. OTHER AUDIT BOARD ACTIONS IN 2016

1. External Audit Tender Process

As KPMG’s existing 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. The four candidatures received met the eligibility terms to continue to the next stage of the procedure. However, one of them declined to submit its written proposal, thereby removing this candidate from the tender process. Following the presentations done by each of the three remaining candidates on 23 and 24 November 2016 and having considered their written proposals, a joint discussion between the EIF Audit Board and the EIB Audit Committee members took place to exchange views. Following this, the Audit Board recommended that KPMG be re-appointed as external auditors and the Audit Committee of the EIB recommended that the firm would also be reappointed as EIB Group external auditors.
2. Joint EIF-EIB audit on the sale of a portfolio of Tail-end funds

EIF’s decision to dispose of tail-end funds in the secondary market represents an important development in its ability to manage its private equity portfolio. The first portfolio secondary sale took place in 2015. The Audit Board closely followed developments in this area with semi-annual updates from the MIBO department.

A joint EIF-EIB internal audit on tail-end funds sale was performed in 2016, following a special request from the Secretary General of EIB and the EIF Chief Executive. EIB’s interest in the transaction derived from the fact that the portfolio being sold had been partly funded through EIB’s Risk Capital Resources (“RCR”) Mandate. The scope of the audit was to provide a view on whether, overall, the secondary market portfolio sale process was robust and well controlled, performed within the boundaries of the RCR mandate, and clearly and sufficiently communicated to the mandator. The audit highlighted areas for improvement in both EIF and EIB, particularly around the questions of clarity and formalisation of roles, as well as communication within and between the two institutions. At EIF, 3 medium AAPs remained open at year end and are due to be closed in June 2017.

The Audit Board considers this joint audit to have been a useful initiative and one which points the way towards further joint audits which can be undertaken at the joint initiative of the Audit Board and the Audit Committee of the EIB.

3. EIF-EIB Compliance synergy

The Audit Board followed developments regarding the achievement of greater synergies between EIB’s and EIF’s Compliance functions, through regular updates and private sessions with the EIF Compliance Officer. A presentation attended by Mr Dominik was made by the EIF Compliance Officer to the EIF Audit Committee and the EIB Group Chief Compliance Officer on 14 December 2016.

4. EIF Audit Board and EIB Audit Committee cooperation

The Audit Board recognises that the EIF’s recent growth means that its business is more material from a group point of view. In light of this, the Audit Board believes that increased cooperation and communication between the EIF Audit Board and the EIB Audit Committee would benefit both institutions. Therefore, it has agreed to hold semi-annual meetings with the EIB Audit Committee. The first meeting was held on the 28 September 2016, at which the secondary sale audit report was presented by Internal Audit.

It was also agreed to prepare in 2017 a Declaration of Cooperation to be signed by the EIF Audit Board and the EIB Audit Committee. This document would aim to provide a framework for discussing common issues and coordinating actions that have an impact on the consolidated financial statements of the EIB Group and its group policies. It would also formalise ways to cooperate and to transparently communicate on the activity, governance and control environment of both institutions.

5. 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. This project is now in the final testing phase.