Audit Approach
Financial Instruments (FI)

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1 - Purpose

Provide guidance and a practical toolbox for the audit of FI;
Cover key audit areas relevant to FI at different levels;
Endeavour a common coherent approach;
Aware of main risky areas.

2 - Audit Objectives and Scope

**Legality & regularity objectives:**
To ensure compliance with applicable regulations;
To ensure consistency with guidelines and interpretations;
To ensure that expenditure declared is legal and regular in all material respects;
To ensure proper and effective management and control over FI operations.
2 - Audit Objectives and Scope

**Sound Financial Management objectives:**
To assess whether principles of sound financial management (i.e. ECONOMY, EFFICIENCY and EFFECTIVENESS) have been met;
To assess consistency with applicable regulations and Commission services guidelines.

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**Comprehensive model audit programme:**
- Phase 1: Preliminary study and planning
- Phase 2: Audit of the Set-up of the FI
- Phase 3: Audit of the Implementation of the FI

**Reference documents:**
- Guidance note on FI under Article 44 of Reg. 1083/2006 (COCOF 10-0014-05 of 8/2/2012);
- Common audit framework for FI in the context of Structural Funds;
- Model Audit work (Phases 1, 2 and 3)
Phase 1: Preliminary study and planning

3.1- Preliminary study and planning

Use

Comprehensive guidance for the preliminary study in order to prepare the AP Memorandum

For efficiency purposes, important preparatory work before the on-the-spot work

Probably not all pieces of information will be available. Will be complemented during the fieldwork.

Key steps

Knowledge of regulations and guidance

Overall understanding of the FI under audit

Identifying risky areas

Preparing the AP Memorandum

Tailoring the model audit check-lists
3.1- Preliminary study and planning

Walk through the Legal framework and guidance

**R1083/2006**: art. 44 (FI), 65.2 (contribution in-kind), 60 (MA and co-financing) and 78 (eligibility of expenditure, recycling of funds and use of interests)

**R 1828/2006**: art. 43 (eligible final recipients, business plan, accounts, management costs, funding agreement), 44 (gap analysis and funding agreement), 45 (only investments in enterprises in early stages or on expansion and only in activities judged economically viable) to 46 (urban development funds)

Application of Sound financial management; art.14 R.1083/2006 and 27.3 & 27.4 and 48 of the Financial Regulation

COCOF guidance note

State aid issues

Public procurement – financial services

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3.1- Get the overall picture of FI under audit

**Key documents** (Background and set up)
- Operational programme
- Market gap analysis
- Funding agreements
- Investment strategy and business plans
- Annual Implementation Report
- Minutes of the Board of HF
- By-laws of HF & FIs
- Management cost letters
- Accounts
- Past audit reports, ... Preliminary discuss, with main actors

- Key aspects (OP objectives, overall business plan and investment strategy, type of products, selection of actors...)
- Current status (state of play, delays, impact, problems of implementation...)
3.1- Overall picture of FI - Key audit areas -

- Member state authorities (MA)
- Holding fund (HF)
- Financial Intermediaries (F. INT.)
- Final recipients

- Accounting records and treasury management
- Reporting
- Recyling and allocation and use of returns and returns
- Design of FEI; structure, actors, contribution and overall business plan
- Management costs
- Targeted final recipients and eligible expenditure
- Share of rules
- Monitoring

3.1- Consideration of risks

RISKS
- STRATEGIC RISKS
  Failure to achieve OP objectives and not addressing main risk areas and difficulties in a timely and effective manner.
- REGULATORY RISKS
- OPERATIONAL RISKS
- VERIFICATION/AUDIT RISKS
- ORGANISATIONAL RISKS
- REPUTATIONAL RISKS
  Delays and low performance of FI will have a high impact on the reputation of all main partners (MA, HF, EC, DG REGIO).

- COMPLIANCE with EC Regulations and guidance
- COMPATIBILITY with OP objectives, investment strategy and agreements
- INHERENT to the operations (structure, financial products and final recipients)
- CONTROL
- SOUND FINANCIAL MANAGEMENT
3.1- Prepare APM and Audit Programme

- Prepare APM and tailor audit programme
- Identify main RISK AREAS
- Obtain good knowledge of FINANCIAL PRODUCTS selected
- Get the OVERALL PICTURE of the FI under audit
- Walk-through the REGULATORY FRAMEWORK

Phase 2: Audit of the Set-up of FI
3.2-Audit of set-up of the FI (Design of FI)

Structure, main actors and responsibilities

Any issues identified?

Contributions (OPs, ERDF, Additional resources (beyond OP contributions, amounts/value, source, timing, type and terms & conditions)

Consistent with OP? Materialised as foreseen?

Selection of Holding Fund manager

Compliant with art. 44 R, 1083/2006?

Overall business plan

3.2-Audit of set-up of the FI

Investment strategy and planning

Consistent with OP objectives and market gap analysis?

Eligible investments and final recipients

- OP contributions
- Eligible investments / financial products
- Eligible final recipients (Enterprises primarily SMEs; at their establishment, early stages or in expansion; Only in activities judged economically viable)

- Be vigilant: no financing of firms in difficulty, mergers, management buy outs and buy ins or family transfers (cf. COCOF guidance note section 3.2)

- No double financing (section 3.1 COCOF guidance note)

- Consistency with OP and monitoring committee selection criteria for the FI operation
3.2-Audit of set-up of the FI

Design of financial products

Product-specific matters (section 4 COCOF guidance note);

Guarantees:
- Multiplier effect between amounts blocked to cover expected and unexpected losses for guarantees (provided or committed) for corresponding new loans
- Ex-ante risk assessment recommended

Interests rate subsidies: possible with FIs, provided they are combined in a single financing package, and the amount reimbursed by the final recipient is not lower than the underlying principal of the loan (no “negative” interest rate)

Compliance with state aid rules

Selected financial products

Specific characteristics (maturity, timing, availability period, target sectors, envisaged recipients, degree of intervention...)

Risk management policy (intended risk profile, diversification, maximum funding levels, capping of expected and non-expected losses...)

Additionally (qualitative and quantitative)

Envisaged performance and targets to be achieved (multiplier, leverage, prompt implementation, recycling, returns and default/losses, maturity, risk profile, operational and financial performance, impact for the OP objectives...)

Understanding? Good level of performance? Be vigilant that the FI is not used to finance only existing loans or liquidity issues of some of the key actors.
3.2-Audit of the set-up of the FI

**Management costs and fees**
- Two separate levels; HF and FI (by products)
- Constitution, level, ceilings, calculation, eligibility and comparison to performance

**Monitoring and reporting**
- From and over the different levels; MA, HF, FI and final recipients
- Monitoring of: a) disbursement of financing at the level of FI and final recipients; b) returns; and c) any other key aspect
- Annex II of COCOF guidance note – indicative list

**Treasury management and financial proceeds**
- Audit trail and MA verifications
- Allocation and use of interests and returns

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3.2-Audit of set-up of the FI

**Selection and agreements with F. INT**
- Approach and planning
- Calls for expression of interests
- Appraisal and selection of F. INT
- (Funding) Agreements with F. INT
- Exit policy and winding-up, including re-utilisation of resources / recycling
  - Provisions in line with Regulatory requirements and COCOF guidance note? Adequate, timely and sufficiently detailed? No major concern of sound financial management?

**Separate block of finance and financial proceeds**

**State aids**
3.3 Audit of implementation of FI

**Holding fund**

*Functioning and effective implementation of the funding agreement*
- In line with designed arrangements? Any other issues identified?

*Implementation of the Investment Strategy Investment*
- Implementation progress and overall performance
- Specific product issues – overall achievements
- In line with expectations and targets? Any other issues identified?
3.3 Audit of implementation of FI

FI (for a sample)

Functioning and effective implementation of the (funding) agreement
In line with designed arrangements? Any other issues identified?

Financial products provided
In line with agreements and business plan? Performance?
Any other issues identified?

Selection of final recipients
Approach / roadmap and testing for a sample of selection procedures & calls for proposals

Final recipients (for a sample)

Normally based on documentation available at FI and HF level
Testing of:
Selection (call, recording of application, evaluation, decision and contracting);
Eligibility (sections 3.1 & 3.2 COCOF Guidance note);
State aids;
Financial products provided:
Contract signed and results
By type: equity, loans, guarantees, seed capital / start-up
Monitoring and reporting
Arrangement fees
3.3 Audit of implementation of FI

**MA and Investment board:**

- Realised management verifications;
- Supervision of management verifications by the MA;
- Effective composition and functioning of the investment / governance board.
  → As planned? Adequate?

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**Main Conclusions**

- **New field of assistance** implemented through FI and involving other or new expertise, procedures, instruments and actors;
- With experience gained over time, expertise will increase;
- **FI to be audited** at several stages throughout the programming period based on progress of implementation (to timely identify issues and adjust before closure / be preventive);
- **Role of FI to be strengthened in the future:** consolidation and expansion of non-grant financial instruments within Cohesion Policy post-2013
Thank you for your attention!