



EUROPEAN COMMISSION

DIRECTORATE-GENERAL

REGIONAL AND URBAN POLICY

EMPLOYMENT, SOCIAL AFFAIRS

AND INCLUSION

Audit

AUDIT METHODOLOGY

for auditing financial instruments in the period 2014-2020

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Legal basis

Regulation	Articles
<p>REGULATION (EU, Euratom) 2018/1046 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 18 July 2018</p> <p>on the financial rules applicable to the general budget of the Union, amending Regulations (EU) No 1296/2013, (EU) No 1301/2013, (EU) No 1303/2013, (EU) No 1304/2013, (EU) No 1309/2013, (EU) No 1316/2013, (EU) No 223/2014, (EU) No 283/2014, and Decision No 541/2014/EU and repealing Regulation (EU, Euratom) No 966/2012</p>	
Reg. Regulation (EU) 2018/1046 of 18 July 2018	Article 2 - Definitions
Reg. (EU) N° 1303/2013 Common Provisions Regulation <i>(hereafter CPR)</i>	Title IV - Financial instruments and all the other applicable Articles for eligibility rules (Articles 2, 65, 69, 70, 71 and 120)
Commission Delegated Regulation (EU) No 480/2014 of 3 March 2014 supplementing Regulation (EU) No 1303/2013 of the European Parliament and of the Council	CHAPTER II PROVISIONS SUPPLEMENTING PART TWO OF REGULATION (EU) No 1303/2013 APPLICABLE TO THE ESI FUNDS SECTION II Financial instruments
Commission Delegated Regulation (EU) 2015/616 of 13 February 2015 amending Delegated Regulation (EU) No 480/2014 as regards references therein to Regulation (EU) No 508/2014 of the European Parliament and of the Council	
Commission Implementing Regulation (EU) No 821/2014 of 28 July 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European Parliament and of the Council	Detailed arrangements for the transfer and management of programme contributions, the reporting on financial instruments, technical characteristics of information and communication measures for operations and the system to record and store data
Commission Implementing Regulation (EU) No 964/2014 of 11 September 2014 laying down rules for the application of Regulation (EU) No 1303/2013 of the European	Standard terms and conditions for financial instruments Templates for "off-the-shelf FIs

Parliament and of the Council	
Commission Implementing Regulation (EU) No 1011/2014 of 22 September 2014 laying down detailed rules for implementing Regulation (EU) No 1303/2013 of the European Parliament and of the Council	Models for submission of certain information to the Commission and the detailed rules concerning the exchanges of information between beneficiaries and managing authorities, certifying authorities, audit authorities and intermediate bodies
Commission Implementing Regulation (EU) 2016/1157 of 11 July 2016 amending Implementing Regulation (EU) No 964/2014	Standard terms and conditions for financial instruments for a co-investment facility and for an urban development fund

European Commission guidance – Financial instruments

Update of guidance

[\(https://ec.europa.eu/regional_policy/en/information/legislation/guidance/\)](https://ec.europa.eu/regional_policy/en/information/legislation/guidance/)

	Publication date
Financial Instruments – Overview of changes in Title IV of the CPR following the Omnibus Regulation	05.03.2019
Guidance Note on implementation options for financial instruments by or under the responsibility of the managing authority)	30.10.2017
Guidance on State aid in European Structural and Investment (ESI) Funds Financial instruments in the 2014-2020 programming period)	12.05.2017
Guidance for Member States on the selection of bodies implementing financial instruments	02.08.2016
New Guidance note about interest and other gains generated by European Structural & Investment Funds support paid to financial instrument (Article 43 Common Provisions Regulation)	25.02.2016
New guidelines on combining European Structural and Investment Funds with the EFSI	22.02.2016
Guidance for Member States on Article 42(1)(d) CPR– Eligible management costs and fees	08.12.2015
European Structural and Investment Funds Guidance for Member States and Programme Authorities CPR_37_7_8_9 Combination of support from a Financial Instrument with other forms of support	11.09.2015
Guidance for Member States on Article 41 CPR– Request for payment	15.07.2015
Guidance for Member States on Article 37(4) CPR, Support to enterprises / working capital	21.04.2015
Guidance for Member States on Financial Instruments - Glossary	21.04.2015
Guidance for Member States on Article 37(2) CPR– Ex-ante assessment)	21.04.2015
EC short reference guide	21.04.2015

1. Introduction

This document presents the audit methodology, an audit checklist and a sampling manual to the audit authorities for the audit of financial instruments (FI) operations co-financed by ESIF in the programming period 2014-2020. The present methodology is prepared with the objective to assist the Commission auditors and audit authorities (AAs) for their audits pursuant to Article 127 of CPR.

It sets out the overall audit approach of the Commission services for carrying out audits of financial instruments in accordance with the applicable rules. It focuses on the key risk areas that might have a material impact in terms of legality and regularity of the expenditure related to the FI operations. This FI related expenditure is part of the annual accounts and is, therefore, subject to the same assurance process as any other type of expenditure. This audit methodology aims to clarify the specificities of the audit work (system audits and audits of operations) related to the nature of the FI operations.

The scope of the audit work should cover the risks related to: (i) the tasks undertaken by the managing authority at different stages of the FIs set up and implementation, (ii) the work performed by the bodies implementing the FI, the Fund of Funds (FoF), if applicable, and all or some financial intermediaries and (iii) the eligibility of final recipients.

The relevant parts of the audit checklist can also be used by the managing authorities while carrying out their management verifications under Article 125 of CPR, which shall be carried out throughout the programming period (based on the progress of implementation) at the level of bodies implementing the financial instrument and, in the context of guarantee funds, at the level of bodies delivering the underlying new loans, when applicable.

2. Key audit areas of Financial Instruments

The investments supported through FIs need to generate revenues or cost savings in order to be financially viable and to allow the return of the investment. The final recipient needs to prove that its project is financially viable through a well-prepared business plan or equivalent. As regards the legality and regularity of the expenditure declared to the Commission, the legal framework allows – only during the eligibility period – to replace ineligible expenditure with other legal expenditure before closure. This mechanism together with the payment regime (in tranches) and the confirmation of the eligible expenditure at the closure of the programme constitutes an in-built corrective mechanism of the eligibility of the expenditure related to the FI.

There are however specific risks linked to the different implementation options (FI implemented directly by the MA or under its responsibility), the involvement of EIB, other IFIs, or National Promotional Banks (NPBs), the different types of financial products (loans, equity, guarantees) and the different phases of implementation (set-up phase, implementation phase and closure when eligibility is confirmed). Typical risky areas include eligibility of expenditure, eligibility of final recipients and underlying investments, eligibility of management costs and fees (including aspects of selection of Fund of Funds and Financial

intermediaries), compliance with State aid rules, compliance with disbursement thresholds (Art. 41 CPR), use of the reflows. All these risks are covered in the audit checklist in Annex I.

All these risks have to be covered through the audit work performed at the level of the MA and the bodies implementing the FI and not at the level of the final recipient, except in duly justified cases (Art. 40(3) CPR).

Work to be carried out by the audit authorities

According to Article 127 of CPR, the audit authorities shall ensure that audits are carried out on the proper functioning of the management and control system of the operational programme (“system audits”) and on an appropriate sample of operations on the basis of the declared expenditure (“audits of operations”).

Following Article 9.2 of Delegated Regulation (EU) 480/2014, the audit authorities shall carry out system audits and audits of operations throughout the programming period at the level of the managing authorities and if necessary, at the level of the bodies implementing the financial instruments, based on the risks identified.

The scope of the audit work for system audits include an assessment of the controls carried out by the managing authority at each stage of implementation of the financial instrument, the review of the work performed by the FoF, if applicable, and by all or some financial intermediaries¹ in respect of the relevant funding agreement. As in general rule, system audits focus on the functioning of the programme’s management and control system and not on single operations. Therefore, the system audits related to FI should focus on the functioning of the systems at the level of the MA and its IBs, where applicable. Due consideration should be given to the fact that the Banks, as regulated institutions, in principle should have strong internal control processes in place.

The audits of operations are carried out on the basis of the declared expenditure included in the accounts. In case of financial instruments, the expenditure declared to the Commission contains the phased application for interim payments (“advances”) of the programme contributions committed to the financial instrument². Due to this construction of the expenditure declared to the Commission, in addition to the checks on legality and regularity of expenditure, the compliance with the conditions set out in Article 41 CPR has to be verified as well. Annex 2 provides detailed guidance on how to verify these conditions in the audit of operations.

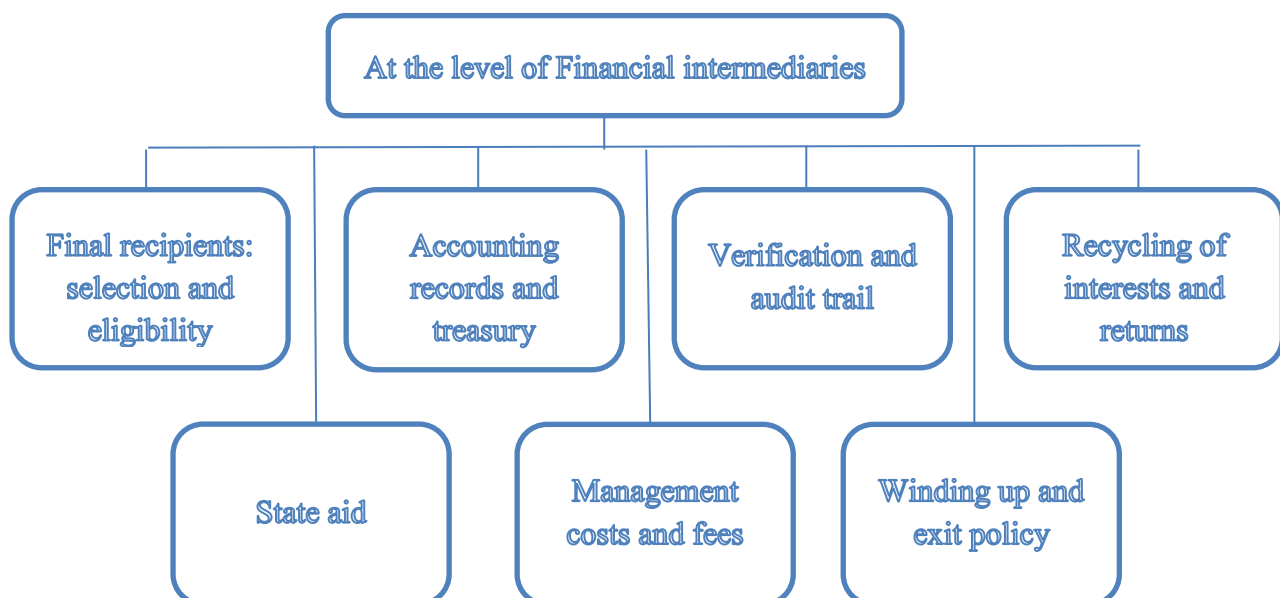
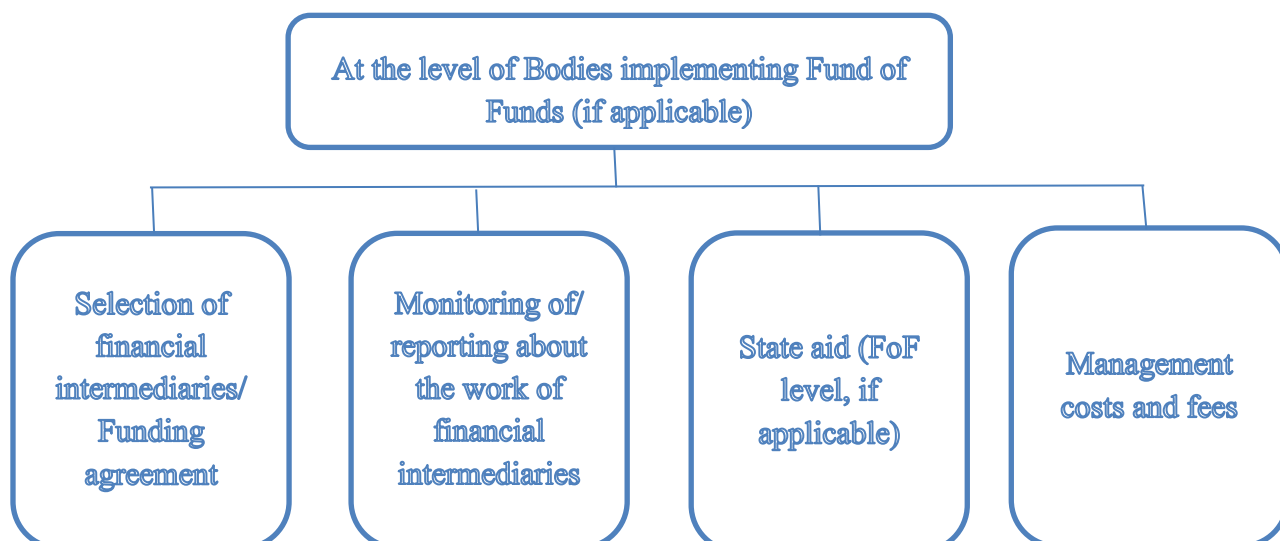
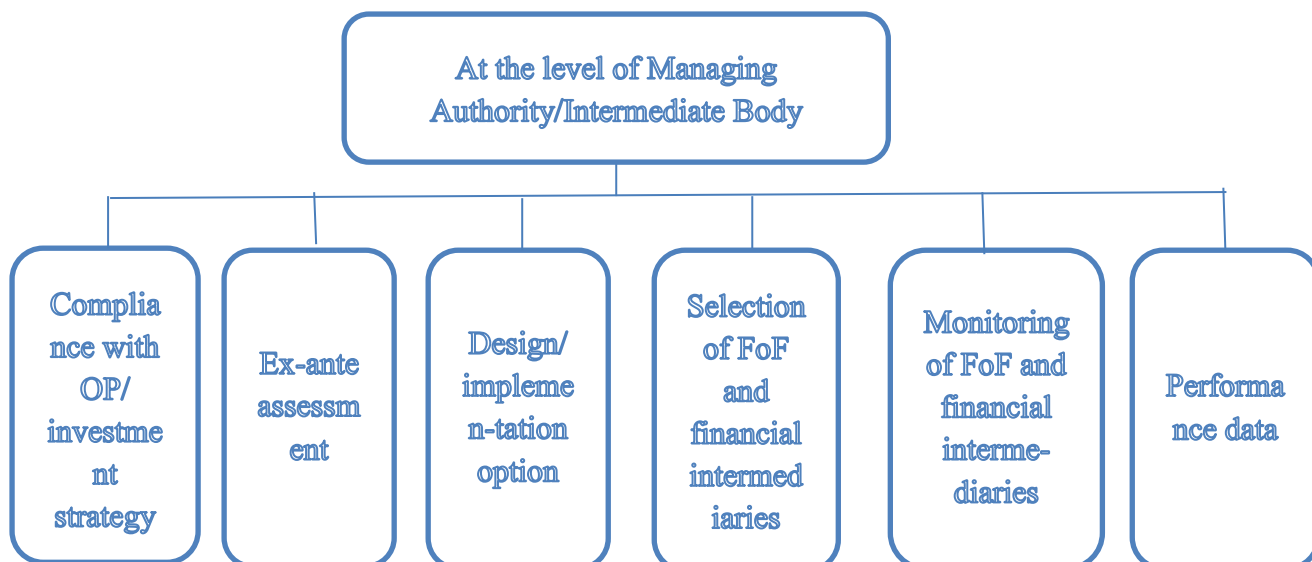
As regards the sampling of the operations at the level of the programme, the audit authorities are recommended to audit the financial instruments in a specific stratum which would facilitate the analysis of the error rate and the actions to be taken in case of deficiencies.

¹ The AA can decide to review in its system audit and in the audits of operations some of the financial intermediaries, depending in general at least on their number and amounts managed. However, while the selection of the sampling items at the level of the FI for the audits of operations is done as a rule in a random manner (see Annex II), the selection for the system audits should follow a risk based selection.

² Except for financial instruments implemented under Articles 38(1)(a) and 38(4)(d) of the CPR.

The checklist set out in Annex 1 may be used as a guidance both for system audits and audits of operations.

A schematic representation of the audit work is presented below:



The audit work to be carried out should be adjusted to the different stages of the FI:

a. Set-up of the FI

This part of the audit checklist covers the ex-ante assessment, the implementation option, the selection of the bodies implementing the FI (FoF and/or financial intermediaries) and the State aid regime under which the FI is implemented. It is reminded that the ex-ante assessment shall be considered as a managerial tool for the MA in the selection of the FI operation. Deviations from the ex-ante assessments in the implementation of the FI are possible and should be justified by the MAs.

For all aspects concerning public procurement, the auditors should use the applicable section of the public procurement checklist. For all aspects concerning the in-depth verification of the state aid rules applied, the auditors should use the applicable section of the state aid checklist for each level, i.e. for the level of the FoF, if applicable, financial intermediaries, final recipients and private co-investors.

The audit of the set-up of a FI will be performed in many cases at the stage of the first tranche declared to the Commission. When the first tranche was not selected for an audit of operation or was covered by a system audit, the audit work on the set-up may be performed at a later stage.

b. Implementation of the FI

This part of the audit checklist covers the eligibility of expenditure, including the part concerning management costs and fees, the eligibility of the final recipients and investments, the payments and the treatment of irregularities.

A special attention is to be put on the payments and the compliance with the condition of a certain level of disbursement for the second and following tranches in the case of findings with financial impact on the eligible amounts.

If, at the moment of audit of the first tranche, there are amounts already disbursed to final recipients or guaranteed loans issued, it is recommended to carry out testing of that related expenditure in order to increase the cost-effectiveness of the audit work. It will help to better distribute the audit work throughout the programming period (as requested in Art 9.2 of Regulation 480/2014). Such testing of related expenditure would also help to reduce the audit burden when auditing the second tranche, where applicable.

Based on Article 41 of CPR, the release of the second and subsequent tranches requires that respectively 60% or 85% of the amounts included in the previous payment applications have been spent as eligible expenditure in the meaning of points (a), (b) and (d) of Article 42(1).

A testing of a sample of the underlying investments supporting the declaration of the expenditure to the Commission shall be carried out at the appropriate level (see Art. 40 CPR). In case of individual irregularities detected at the level of final recipients, it should be concluded whether there is a compliance issue with the phased payment (threshold not

reached) and whether the related expenditure needs to be withdrawn from a payment application or deducted directly from the accounts.

Annex 2 provides detailed guidance on how to verify the Article 41 conditions in the audit of operations. In particular, it presents elements of the sampling design for a random sample to evaluate compliance with the 60% and 85% thresholds.

If the audit authority has to verify the third and subsequent tranches, the 85% implementation threshold related to all preceding tranches has to be checked. If the FI operation was already subject to previous audits by the AA, EC or ECA two and multi-period sampling designs can be applied to use the results of audits carried out previously. Annex 2 includes an example illustrating such an approach as well.

c. At closure of the financial instrument, confirmation of the eligibility (Article 42 of CPR)

The audit authorities are expected to obtain the assurance that the final amounts declared at closure³ are eligible.

For FIs subject to Article 41 CPR, at least the implementation related to the last tranche as well as up to 15% of the amounts included in the previous tranches will not be covered by previous audits of operations. The assurance for the legality and regularity of this expenditure should be obtained by the AAs before submission of the last accounts. The AAs are expected to report how they have obtained this assurance and to confirm to the Commission the final eligibility of the expenditure spent under FIs with the last Annual Control Report.

For FIs at closure, it is recommended that the AA covers the remaining population not covered previously during audits of operations. The AA may decide to group financial instruments for the purposes of their audits (under the same management and control system) bearing in mind that then the results will be applicable to all financial instruments within the group. The following approach is possible:

- a random approach, or
- a mixed approach with some FI selected based on risk assessment and some FI selected randomly.

The AA should carry out an audit of a statistical sample of investments/management costs and fees for the eligible expenditure not covered in the framework of previous audits of operations. The AA could treat such expenditure as an additional audit period in order to use the results of audits carried out previously (see example in Annex 2).

³ Closure means either the closure of the instrument or the closure of the programme at the end of the programming period, whichever earlier.

3. Specificities for the audit of financial instruments implemented by EIB and other international financial institutions

(Article 40 CPR as amended by Regulation (EU) 2018/1046)

Article 40 was amended to harmonise the control and audit requirements and to improve the accountability of the financial instruments implemented by the EIB and other international financial institutions.

- The audit authorities shall not carry out audits at the level of EIB or other international financial institutions in which a Member State is a shareholder, for financial instruments implemented by them.

The EIB and other international financial institutions in which a Member State is a shareholder shall provide to the Commission and to the audit authorities an annual audit report drawn up by their external auditors. The adoption of the Implementing Act⁴ ensures a uniform application of this provision by setting out a model for the annual audit reports.

In the annual audit report, the external auditor will conclude whether the internal control system of the EIB or other international financial institutions provides reasonable assurance regarding the set-up of the instrument.

- The amended Article 40 also clarifies that the audit authorities shall carry out system audits and audits of operations at the level of other bodies implementing the financial instruments in their respective Member States. Audits at the level of the final recipients can be performed only if the conditions set out in Article 40(3) CPR are fulfilled.

The EIB or other international financial institutions shall provide to the audit authorities all the necessary documents available to them to enable the audit authorities to carry out these audits.

Article 40 establishes a similar provision for the management verifications in accordance with Article 125(5) CPR.

By analysing all audit results and conclusions of the two phases described above (set-up at the level of EIB and implementation at the level of financial intermediaries), the audit authorities will be in a position to issue their annual audit opinion in accordance with Article 127(5) CPR. The Annual Control Report should disclose information on the audit work on financial instruments.

4. Treatment of irregularities in financial instruments

Legal references:

⁴ Expected to be adopted by end June 2019

Article 41(1) of the CPR defines the moment of certification of the amount of eligible expenditure under FIs to the Commission as:

At closure of a programme, the application for payment of the final balance shall include the total amount of eligible expenditure as referred to in Article 42.

Article 40(5a) of the CPR treats the reuse of resources inside a FI:

By way of derogation from Article 143(4) of this Regulation and from the second paragraph of Article 56 of Regulation (EU) No 1306/2013, in operations comprising financial instruments, a contribution cancelled in accordance with Article 143(2) of this Regulation or in accordance with the first paragraph of Article 56 of Regulation (EU) No 1306/2013, as a result of an individual irregularity, may be reused within the same operation under the following conditions:

- (a) Where the irregularity that gives rise to the cancellation of the contribution is detected at the level of the final recipient, the contribution cancelled may be reused only for other final recipients within the same financial instrument;*
- (b) Where the irregularity that gives rise to the cancellation of the contribution is detected at the level of the financial intermediary within a fund of funds, the contribution cancelled may be reused only for other financial intermediaries.*

Where the irregularity that gives rise to the cancellation of the contribution is detected at the level of the body implementing funds of funds, or at the level of the body implementing financial instruments where a financial instrument is implemented through a structure without a fund of funds, the contribution cancelled may not be reused within the same operation.

Where a financial correction is made for a systemic irregularity, the contribution cancelled may not be reused for any operation affected by the systemic irregularity.

The above Article results in the following cases:

Treatment of irregularities

In Financial Instruments there are three levels of implementation:

- Fund of Funds (FoF) (if applicable)
- Financial intermediaries
- Final recipients.

Irregularities can occur at each of these levels. The irregularities can be of individual and systemic nature:

As a matter of principle, any **individual irregularity** identified during audits and controls cannot be replaced with other eligible expenditure of the same body at which the irregularity was identified. More specifically:

- irregularities at the level of the FoF cannot be replaced with other eligible expenditure of the FoF. These irregularities cannot be reused in the same Financial Instrument. The concerned amounts can be reused in the programme for other Financial Instruments or for grants.
- irregularities at the level of the financial intermediary cannot be replaced with eligible expenditure of the same financial intermediary⁵ but can be replaced with eligible expenditure from other financial intermediaries, and
- irregularities at the level of a final recipient cannot be replaced by eligible expenditure of the same final recipient but can be replaced with eligible expenditure from other final recipients.

In case there are **systemic weaknesses** identified in the functioning of the MA, its IBs, the FoF and/or the financial intermediary, the body/ies concerned have to correct the irregular practices. The AA (or the external auditor in case of EIB/EIF) can then confirm that from now on the bodies function properly and subsequently only disbursements made through the improved system can be used to replace irregular expenditure. If the system cannot be improved anymore, i.e. in case all investments have already been disbursed, and in line with the above CPR Article, the contribution cannot be reused for the same FI. Those irregularities will as well lead to a reduction of the ESI Funds allocation to the concerned FI and can be reused in the programme for other FIs or grants⁶.

All irregularities should be clearly described in the Annual Control Report of the year when they are established. The corresponding corrections of irregularities should be part of the audit follow-up of the AA. However, as these irregularities are related to phased payments (i.e. advances) they are not included in the calculation of the total error rate.

In the accounts, appendix 6 (columns C and D) should always contain the amounts of eligible expenditure. Therefore, all irregularities should be deducted from those amounts in the next accounts.

Where applicable⁷, the ineligible amounts should be corrected vis-à-vis the Commission when the concrete irregular amount is finally established. This can be at the next possible occasion/request for payment of a tranche, or at latest at programme closure.

Compliance with the threshold for payment of the second and following tranches (Art. 41(1)(c) CPR)

⁵ In case of only one financial intermediary involved, the same rule as the one above for FoF applies.

⁶ Except for SME initiative programmes, where the reduced amount cannot be reused.

⁷ Ineligible amounts can be due to irregularities already established during the implementation of the Financial Instrument (for example, public procurement irregularities related to the selection of the FoF or the financial intermediaries) for which, however, the final ineligible amount can be established only at closure. Alternatively, ineligible amounts can be due to irregularities established at closure (both related to the FoF, financial intermediaries and/or the final recipients) which cannot be anymore replaced by eligible expenditure.

During the implementation of the financial instrument, some of the phased applications for interim payment (the tranches) will be selected by the AAs for its audits of operations. The AA will have to verify if the conditions for the payment of the tranche are fulfilled, i.e.:

- The condition for the first tranche is that the instrument is set-up;
- The condition for the second tranche is that at least 60% of the amount of the first tranche has been spent as eligible expenditure;
- The condition for the third and following tranches is that at least 85% of the previous tranches has been spent as eligible expenditure.

Should the AA conclude that the conditions for the payment of a tranche are not fulfilled, the AA should:

- Request the MA/CA to carry out corrective measures before the submission of the accounts meaning:
 - the deduction of the amount for the related tranche, or
 - proving that enough additional eligible expenditure is available to reach the legal threshold for the following tranche, and/or
 - improve the functioning of the system / correct systemic weaknesses at the level of MA/IB but also with regard to FoFs and financial intermediaries (if applicable).
- Report the audit finding in its Annual Control Report (ACR).
 - In case the legal threshold for the payment of the following tranche was not reached before the submission of the accounts and this is confirmed by the AA, this finding should be analysed by the AA. It should draw conclusions on the functioning of the FIs in the programme (including audited and non-audited FIs) and described it in the ACR. In some cases, additional audit work might be considered. The error should be added to the total error rate. The MA/CA should deduct the amount from the accounts. The withdrawal of the tranche should be included to the corrections performed for the calculation of the residual total error rate. However, this amount is not a definitive financial correction and can be re-introduced once the condition for the payment of the tranche is fulfilled. The finding will be considered for the audit opinion on the legality and regularity of the expenditure in the accounts.
 - In case the legal threshold for the payment of the following tranche was reached before the submission of the accounts, the AA will report this finding as a compliance finding.
 - With regard to findings related to the management and control system and/or systemic weaknesses, the AA will report in the ACR the state of its implementation and will reflect this finding in the audit opinion on the management and control system.

Annexes

Annex 1 - Audit checklist

Annex 2 - Sampling methodology for financial instruments

Annex 3 - Special provisions for documentation of investments in working capital