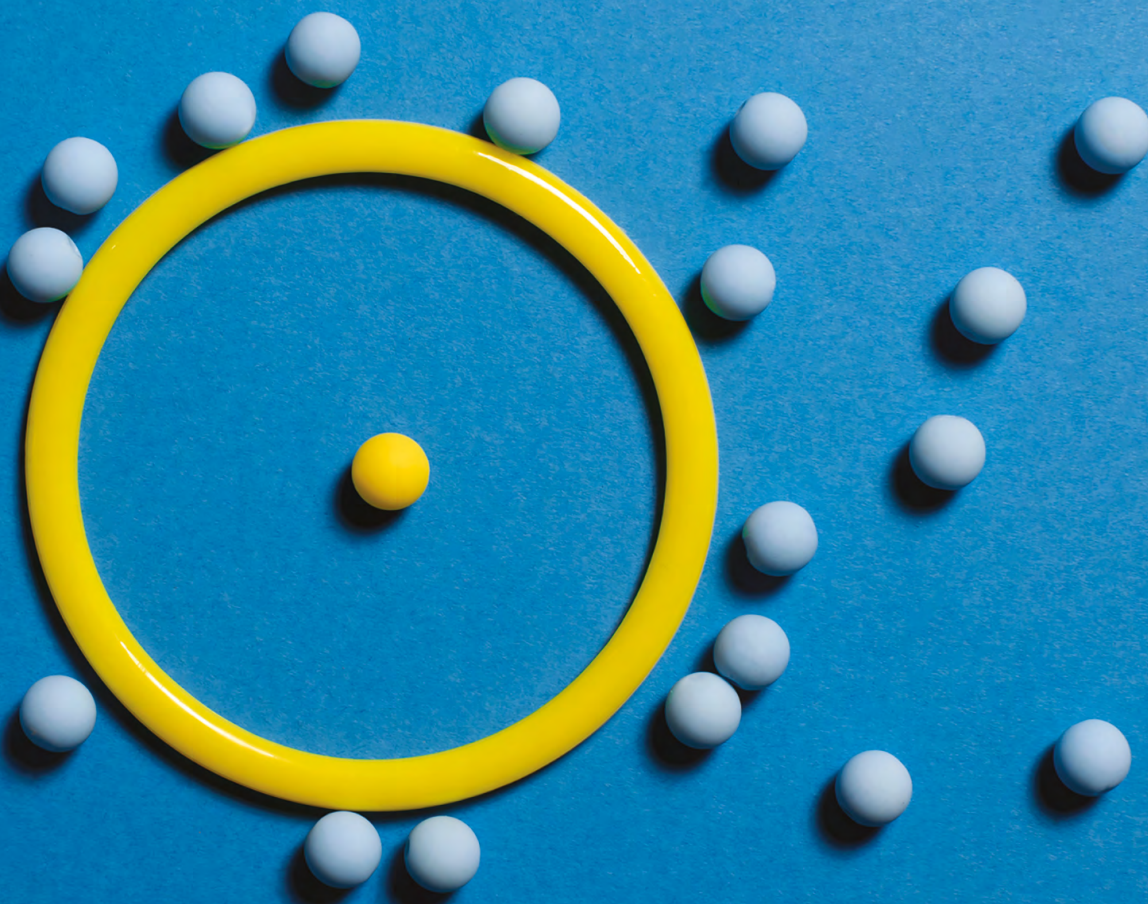




Factsheet
March 2024



fi-compass Knowledge Hub

Audit of financial instruments in the 2021-2027 programming period



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The Knowledge Hub

has been developed to meet the growing need amongst experienced practitioners for events and materials that provide a more in-depth look into topics affecting financial instruments. Its format utilises email exchanges to promote a longer term engagement between participants together with traditional face to face workshops to allow experienced practitioners to work together to explore the subject matter through peer to peer exchange and expert-led sessions.

In order to encourage openness between the parties the discussions are undertaken under the Chatham House Rule which states: 'When a meeting, or part thereof, is held under the Chatham House Rule, participants are free to use the information received, but neither the identity nor the affiliation of the speaker(s), nor that of any other participant, may be revealed.'

In particular, the representatives of the European Commission, DG REGIO have participated in the Knowledge Hub to receive feedback from the Member States concerning the audit methodology for financial instruments in the 2021-2027 programming period. The participation of the representatives of the European Commission and the European Investment Bank should not be interpreted as an official endorsement of any of the suggestions that may be discussed and/or described during the Knowledge Hub.



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Introduction

The European Commission (EC) has published the methodology for the audit of financial instruments (FIs) in the 2021-2027 programming period (the 2021-2027 audit methodology)¹. The approach in the 2021-2027 audit methodology reflects the requirements of the Common Provisions Regulation 2021/1060 (CPR), in particular:

- Articles 58-62, 92 rules governing the setup and implementation of FIs;
- Article 68 specific eligibility rules for financial instruments;
- Article 74 risk-based management verifications;
- Article 81 general principles of management verifications and audit for FIs (reduced scope under Article 83 enhanced proportionate arrangements);
- Articles 77 and 79 system audits and audits of operations.

The 2021-2027 audit methodology follows the EC's approach to the CPR by seeking to simplify the rules relating to FIs in the CPR. The early publication of the 2021-2027 audit methodology is intended to further enable the efficient implementation of FIs and associated control and audit provisions by managing authorities and audit authorities.

On 3 July 2023, a group of practitioners (representatives of managing authorities, audit authorities, national promotional banks and bodies implementing financial instruments) gathered in Brussels with experts from the European Commission (EC) and European Investment Bank (EIB) to take part in a workshop to discuss the 2021-2027 audit methodology. This Note captures the key points discussed, best practice shared and lessons learned during the workshop.

¹ Audit methodology for auditing financial instruments, programming period 2021-2027 CPRE_23-0011-01 24/10/2023. Available at the fi-compass website here: <https://www.fi-compass.eu/library/other/guidance/audit-methodology-auditing-financial-instruments-programming-period-2021>.

02 Key notes

The 2021-2027 audit methodology puts forward an audit approach aligned to the legal framework for 2021-2027 programming period. This will facilitate the smooth application of the 2021-2027 audit methodology in the audit work.

Although the 2021-2027 audit methodology is strictly only binding on the European Commission's auditors, it was acknowledged that it effectively provides an overview for the design of managing authorities' control and monitoring systems and it proposes the audit approach on FIs to audit authorities.

The participants welcomed and acknowledged that the new methodology includes flexibilities designed to streamline and simplify certain audit processes which follow from the simplified and streamlined rules in the CPR 2021-2027. This creates opportunities to further develop the audit and control mechanisms adopted by both audit authorities and managing authorities for the current programming period in line with the principles set out in the new methodology.

The principle of 'single audit and proportionality' is at the heart of the new methodology and practitioners in Member States are strongly encouraged to embrace these principles when designing their audit plan and associated monitoring and control processes.

The 2021-2027 audit methodology describes how audit work may be planned to avoid duplication of audits of the same expenditure with the objective of minimising the cost of the audit and administrative burden on the bodies implementing FIs. Auditors should first use the information and records at MA level or Holding Fund level and request additional documents and audit evidence from the bodies implementing FIs only when needed.

No audits or management verifications can be performed at the level of the final recipients. The bodies implementing the FI shall monitor final recipients in accordance with their normal business practices.

Although this is already established practice, the principle that FI audit and management verifications do not take place at the level of the final recipient was repeatedly returned to during the workshop. It is expected that banks and other bodies implementing the FI will monitor the performance of the loans/investments in the same way as they would manage similar clients of their business, unless any specific evidence is required by the CPR or national rules (e.g. in relation to eligibility and visibility). The approach to monitor performance of the loans/investments will be described in the Funding Agreement. This will reflect the proposals submitted by the body implementing the FI during the selection process that led to its appointment.

System audits can play a valuable role in the development of effective management processes by managing authorities. When a system audit is carried out at an early stage, the audit recommendations can play a proactive role whereby potential weaknesses in control systems can be identified and rectified, avoiding problems later in the implementation.

Participants endorsed this view and commented positively on the 2021-2027 audit methodology which depicts the review process of FI implementation systems. It was acknowledged that whilst a system audit can be carried out at any time, in many cases a proportionate audit plan is unlikely to require such audit activity at the end of the period, where any recommendations would be too late to be usefully implemented unless the recommendations are meant to be implemented in the subsequent programming period (the management and control system implemented for FIs in 2014-2020 programming period remains essentially the same as the one already implemented in 2021-2027 programming period).



The audit of the design and set-up of the FI is generally practical and easy to implement. Checks are related to the ex-ante assessment, selection of the bodies implementing the FI and Funding Agreement/Strategy Document.

The objective of the 2021-2027 audit methodology is to ensure that the requirements of the CPR are observed in relation to the minimum requirements of the ex-ante assessment (Article 58(3) CPR) and template of Funding Agreement/Strategy Document (Annex X CPR). Selection (including continuation of existing agreements) should be reviewed in relation to the applicable public procurement rules in the Member State. In relation to coherence between the ex-ante assessment and the implemented FI, any departure from the ex-ante assessment should be justified, although it is not necessary for the ex-ante assessment to be formally amended.

There is a major change to the way in which the support provided should be verified in respect with the intended purpose. Annex XIII CPR requires that the verification, both for management verifications and audits, should be based on the intended use of the support provided through the FI. Thus, use for intended purpose is justified by reference to forward looking documents such as the final recipient's business plan or equivalent documents, application, investment decisions or other supporting documents relating to the proposed use and NOT the invoices of expenditure subsequently incurred.

The discussion during the Knowledge Hub reflected that there existed a degree of uncertainty at present amongst both audit authorities and managing authorities about how to take best advantage of this new flexibility. It was generally acknowledged that this could simplify the process to verify eligibility for bodies implementing FIs and that this was to be welcomed. Nevertheless, managing authorities and bodies implementing HFs will need to provide support to their bodies implementing SFs to ensure clarity of what will be required, and this should be aligned with the expectation of audit authorities. It will be interesting to see how Member States take advantage of this flexibility in the coming years. At the same time, this flexibility provided by the CPR should not preclude the bodies implementing FIs to continue applying the same standard of verifications when deploying programme support as when doing verifications for their own funds. In conclusion, once evidence that the support provided 'is to be used for its intended purpose' is available for verification at the level of the body implementing the instrument, no further verifications of this point is needed. Furthermore, there is no requirement for a subsequent check that the support was used for its intended purpose.

When FIs and grants are implemented in a single FI operation, the grant component is verified and audited in accordance with the FI rules. The 2021-2027 audit methodology includes specific clarifications for such FI/grant combinations as well as addressing the risks when an FI is combined with a grant in two separate operations.

During the design and set-up of the combined grant and FI in a single FI operation, compliance with the requirements of Article 58(5) CPR may be reviewed, in particular, the analysis to show that the use of grant is necessary and directly linked to the FI. This should be done at the level of the FI and either be part of the ex-ante assessment or in a separate analysis. During implementation it is required that separate records are maintained for each component which will facilitate monitoring and control of such instruments.

When designing a sampling methodology for the 2021-2027 period there is no obligation to consider the FI operations in a separate stratum.

Unless the audit authority considers it to be reasonably necessary, based on their professional judgement, FIs could form part of the sampling population for that programme. If material errors are expected in the FI operations, the stratification of the FI expenditure from the rest of expenditure may be justified. Experience of the 2014-2020 period suggests that FIs do not give rise to more irregularities than grant operations (and often fewer). Thus, it is expected that, unless a specific heightened risk is identified for a particular FI operation, FIs do not need to be separated from grant operations for the purposes of sampling in the current period.

03

An introduction to the new audit methodology

3.1 Scope of the new methodology

The scope of the 2021-2027 audit methodology is to describe the audit approach to be adopted by EC auditors, provide orientation to the audit authorities (AA) in each Member State and provide MAs a tool for designing and implementing FIs in line with the control and audit requirements of the CPR.

The participants considered the structure of the 2021-2027 audit methodology and Annex, with particular focus to the questions in the checklist. During the session the relevant questions under the checklist were considered alongside the related audit methodology concepts. It was commented that the checklist is a tool for audit authorities to use. Additional questions may be added to reflect local needs and requirements.

In addition to the CPR, other relevant legal requirements for the audit of financial instruments in the 2021-2027 programming period include the Sampling Regulation (EU) 2023/67² (the Sampling Regulation), the Fund specific rules as well as the programme requirements and eligibility rules at the national level.

3.2 Risk areas for audit work

The 2021-2027 audit methodology identifies the principal risk areas to be considered during audits and recommends audit procedures in relation to both 'system audits' (of the management and control system) and 'audit of operations' (at design/set-up, implementation and closure). Figure 1 shows the key risk areas and their application depending on the implementation mode adopted by the MA, to be included in the audit scope.

² Commission Delegated Regulation (EU) 2023/67 of 20 October 2022 supplementing Regulation (EU) 2021/1060 of the European Parliament and of the Council by establishing standardised off-the-shelf sampling methodologies and modalities to cover one or more programming periods.

Table 1: Risk areas for verification depending on implementation mode

Verifications	CPR Ref.	Implementation directly by the MA Art 59(1): MA=Beneficiary	Implementation under the responsibility of the MA - Art 59 (2)
Risk based administrative verifications	Art 81 (1)	x	x
Verifications of reports/payment claims from HF/SF			x
Risk based on-the-spot verifications	Art 81 (1)	x	x
Direct Award of contract to the body implementing the FI (HF/SF)	Art 59 (3)		x
Selection of the body implementing the FI (HF/SF)	Art 59 (4)		x
Verifications of eligibility	Art 64, Art 68		
Final recipient		x	x
Support is to be used for intended purpose		x	x
Management costs and fees (MCF)			x
Combination of FI with grants	Art 58 (5)	x	x
Visibility rules	Art 50	x	x
Audit trail	Annex XIII	x	x

When developing an audit plan, audit authorities should identify the risk areas and define the audit procedures to be adopted. This may include a combination of both system audits (Article 77 CPR), which assess the controls and systems in place for the FI and audits of operations (Article 79 CPR) which look at both the design and set up and implementation of FIs.



3.3 Single audit and proportionality

Audits of financial instruments in the 2021-2027 programming period have to take due account of the ‘single audit and proportionality’ principles in relation to the level of risk to the budget of the Union.

Paragraph 1 of the audit checklist emphasises this by providing that the audit should be performed in cascade, depending on the availability of information. This approach reflects the requirements of Articles 80(1), 81(3)-(5) and 83 CPR. This is in line with Article 81(1) CPR which provides that verifications for financial instruments are to be carried out only at the level of bodies implementing financial instruments.

Similarly, for guarantees, audit is only conducted at the level of the bodies providing new underlying loans when at least one of the situations in Article 81(4) has occurred.

Figure 1: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 1 - 2

<p>1. The audit performed in cascade, depending on the availability of information, at the level of:</p> <ul style="list-style-type: none"> a. Audit Authority (in the case of Commission audits); b. Managing Authority; c. Body implementing a Holding Fund (HF), if applicable; d. Body implementing a Specific fund (SF). 	<p>Art. 80(1) Art. 81(3) -(5) Art. 83</p>
<p>2. For guarantee funds, the <i>audit is conducted at the level of bodies providing new underlying loans only when at least one of the situations described in Art. 81(4) CPR occur.</i></p>	<p>Art. 81(4)</p>

The methodology thus describes how audit work may be planned to avoid duplication of audits of the same expenditure with the objective of minimising the cost of the audit and administrative burden on beneficiaries.

It was stressed during the discussion how important it was to emphasise that audit should not be conducted at the level of final recipients.

Some of the grounds for limiting the work of managing authorities and audit authorities were discussed by the group. These can include:

- Where the principles of single audit and proportionality apply. Article 80 CPR requires the Commission and the audit authorities to ‘take due account of the principles of single audit and proportionality in relation to the level of risk to the budget of the Union’;
- When the results of audits by external auditors of the bodies implementing the FI can be taken into account. Article 81 CPR enables both managing authorities and audit authorities to take account of audits by external auditors and may limit their requests for information accordingly;
- When enhanced proportionate arrangements apply. Articles 83-84 CPR enables more streamlined arrangements for management verification and audit where the management and control system of the programme is functioning effectively, and the total error rate is 2% or below for each of the previous two years.



These provisions of the CPR thus empower managing authorities and audit authorities to further develop their approach to management verifications and audit in line with the new methodology to reduce the burden on beneficiaries and minimise cost. One example of how this could be achieved was referred to in relation to the scope of system audits conducted during implementation. As described below, system audits focus on the management and control framework put in place by MA/IBs for the management verifications of FIs.

It was also acknowledged that no on-the-spot verifications or audit authority audits shall be conducted at the level of the EIB or other international financial institutions (Articles 81(2) and (5) CPR).

The discussion between participants during the workshop highlighted the importance of coordination between the auditors (EC, Audit Authority, ECA) and managing authority in order to achieve alignment with the principle of single audit and proportionality. A proactive engagement between the audit authority and managing authority from the outset of the programme is recommended in order to achieve this and participants recognised that, if properly planned, audit activity can add value to the design and implementation of FIs. One idea that was proposed during the session consisted in organising targeted trainings for audit authorities on FIs. This could be provided at national level or maybe at EU level and could be done in partnership with managing authorities. Such training could be particularly useful for newcomers who have not previously worked on audit of FIs.

The role of the European Court of Auditors (ECA) was also discussed in the context of securing alignment with the single audit and proportionality principle. Participants expressed the interest to explore finding synergies between different audit approaches (ECA, EC, AA). It was recognised that by nature, ECA must act independently. Nevertheless, there may be scope to identify opportunities to further align the different audit approaches in the future.



04 System audits

System audits will assess the key requirements of the controls and underlying systems put in place for the FI. System audits seek to verify the functioning of the management and control system rather than the audit of individual projects/investments. It may consider the monitoring system that enables managing authorities to verify the activities of the HF/SF functions.

This is done through a risk-based sampling process and can be undertaken at the level of the bodies implementing the FI, including the MA, Holding Fund (HF) and Specific Fund (SF).

In the case of guarantees, banks delivering the underlying new loans may also be subject to system audits.

Figure 2: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 3 - 4

<p>3. The MA has an effective control system in place to monitor the bodies implementing the FI/ bodies delivering the underlying new loans:</p> <ul style="list-style-type: none"> a. to monitor the work of the HF (if applicable); b. to monitor the work of the SF (where there is no HF structure). <p>Perform a walk-through and test the control system in place. Report on deficiencies identified (if any).</p>	<p>Art. 77 Art. 81 Art. 74(2)</p>
<p>4. In case of weaknesses in the implementation performed by the HF (if applicable) and the SF, the MA has taken appropriate measures to mitigate the impact on the EU Funds.</p>	<p>Art. 81</p>

During the discussions, the Methodological Note³ for the assessment of management and control systems in the Member States was highlighted as a reference paper which identifies the ten key requirements that are applicable inter alia to system audits of financial instrument operations. These key requirements are detailed in Annex XI CPR and are summarised as follows:

System audit – key requirements	
The organisation, including separation of functions	IT system
Selection of operations	Fraud – prevention, detections and correction
Communication with beneficiaries	Management declaration
Management verifications	Legality and regularity of expenditure entered in the accounts
Audit trail	Drawing up of payment applications and accounts, confirming completeness, accuracy and veracity of the accounts

³ Methodological Note for the assessment of management and control systems in the Member States (CPRE_23-0007-01 24/05/2023)



Further information about the assessment criteria for each of the above key requirements can be found in the Methodological Note for the assessment of management and control systems in the Member States.

Participants welcomed the fact that the audit methodology focussed on the managing authority's management and control system. Financial institutions and other bodies implementing FIs have their own systems for their own business activities, aligned with industry practice. The same systems may be used for the implementation of the FIs. A distinction should be made between the HF/SF system to provide the MA with the information required under the Funding Agreement (which is in the scope of the system audit at MA level) and a financial institution's systems for managing their own portfolio of loans or other investments (which would usually be out of scope). The audit methodology for FIs is designed such as to gain reasonable assurance on the legality and regularity of the expenditure declared to the Commission.

A further discussion concerned the timing of system audits during the programming period. An example was shared of a Member State which is currently undertaking a system audit of a managing authority in the final year of implementation of the 2014-2020 programming period.

Participants commented that when undertaken at the start of the operation, following the set-up of the FI, a system audit can be helpful for a managing authority. An early review of the systems that have been put in place can provide assurance that the operation is well designed. Similarly, recommendations made following a system audit can be helpful as it would allow control systems to be amended at the start of the programme. On the other hand, the usefulness of a system audit at the end of the programme is much reduced, in particular, where any recommendations are made too late to enable them to be adopted during the implementation period, unless measures are in place to ensure the recommendations are rolled-over the subsequent programming period.

It was commented that this proactive role of a system audit was reflected in the requirement under Article 78(1) CPR for a system audit to be carried out by audit authorities where a managing authority and/or authority in charge of the accounting function is implementing an FI or grant programme for the first time. Such audits shall be carried out within 21 months of the decision approving the programme or the amendment of the programme identifying such an authority.

Participants also highlighted potential scenarios where an audit of operation may identify irregularities which might trigger a system audit later in the programme. It was, therefore, the case that in principle, a system audit may be carried out at any time, and it would be wrong to say that it cannot be done towards the end of a programming period. Nevertheless, bearing in mind the principle of single audit and proportionality, it might be expected that system audit activity is focussed on the early part of the programme implementation where its added value will be highest.

05

Audits of operations: design and set-up of FIs

The workshop next considered the approach for audit of operations. It was pointed out that the sampling rules do not require stratification of the population to ensure that FIs are sampled separately. FIs can be included in a single sampling population along with the programme's grant operations (see section 7 below).

The audit of the design and set up of FIs can be done at any time in the programming period, either during system audits or audits of operations.

5.1 Ex-ante assessment

The requirements of the 2021-2027 audit methodology focus on three aspects of the ex-ante assessment:

- Whether it includes the minimum requirements under Article 58(3) of the CPR;
- That the ex-ante assessment was performed prior to the managing authority making programme contributions to the FI; and
- That there is coherence between the ex-ante assessment and the FI that are subsequently implemented by the managing authority.

Figure 3: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 5 - 7

5. The ex-ante assessment includes at least the following elements: a. the proposed amount of programme contribution to a financial instrument and the estimated leverage effect accompanied by a short justification; b. the proposed financial products to be offered, including the possible need for differentiated treatment of investors; c. the proposed target group of final recipients; d. the expected contribution of the financial instrument to the achievement of specific objective.	Art. 58(3)
6. Check whether the ex-ante assessment was performed before the MA makes programme contributions to the financial instrument.	Art. 58(3)
7. Check whether the amounts of programme contribution, the estimated leverage effect, the financial products or the target group are in line with the ex-ante assessment. In case of inconsistencies/ deviations, obtain justifications from the MA.	Art. 58(3)



During the session it was highlighted how any deviations identified during the audit of the ex-ante assessment could potentially give rise to observations in the audit report and recommendations for action. There is no financial adjustment attached to findings in relation to this aspect of FIs.

It was also acknowledged that when auditing the ex-ante assessment, auditors are not expected to re-perform the ex-ante assessment and reach their own conclusions regarding the use of FIs by the managing authority.

During the discussion, participants indicated that it was relatively straightforward to both achieve and verify/audit compliance with the requirements of Article 58(3) of the CPR. Reference was made to the fact that in the current programming period the ex-ante assessment was often a short and straightforward document addressing the CPR requirements and providing a tool for the management of the design and set up of the FI.

The ex-ante assessment is expected to be completed prior to the programme contributions are made to the FI.

Where a managing authority is relying on an update of an existing ex-ante (as permitted under Article 58(3) CPR), for either a new FI or when an existing FI is continuing into the next programming period, the audit shall verify whether the update of the ex-ante assessment was finalised before the new contribution to the FI was paid.

There was, however, some discussion about the issue of coherence between the ex-ante assessment and the FIs that are ultimately implemented. It is standard practice for the managing authority to refine the Investment Strategy throughout the period following finalisation of the ex-ante assessment to the set-up of the FI. Therefore, it is to be expected to see this throughout the selection process and subsequent finalisation of the Funding Agreement. When such refinements are inconsistent/deviate from the ex-ante assessment, the audit methodology only requires such inconsistencies/deviations to be justified and does NOT require the ex-ante assessment to be redone or updated.

5.2 The Funding Agreement/Strategy Document

The 2021-2027 audit methodology aligns audit activity with the CPR requirements and in particular Annex X CPR. The alignment of the Funding Agreement/Strategy Document with the minimum requirements in the CPR will be looked at during the audit and, in the event that deviations are found, the usual remedy will be observations/recommendations in the subsequent audit report. No financial implications will normally result in relation to this issue.

Paragraph 15 of the audit checklist brought about some interesting discussion during the workshop about the issue of implementation of FIs across consecutive programming periods, for example when an FI implemented during the 2014-2020 programming period receives additional resources from the current programme (2021-2027). It is also relevant if the FI is set up under 2021-2027 programming period and will continue in the subsequent programming period. In such cases the audit should consider whether the continuation of the FI or where applicable extension/amendment of the Funding Agreement has been done in accordance with the applicable public procurement rules as well as meeting the requirements of the CPR regarding separate record keeping and eligibility of expenditure.

Figure 4: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 13 - 19

13. In case the financial instrument is implemented directly by the MA, check that the strategy documents include the elements mentioned in Annex X/2 CPR.	Art. 59(1) Annex X
14. In case the financial instrument is managed by the body implementing the FI (a HF or a SF), check that the funding agreement includes the elements mentioned in Annex X/1 CPR.	Art. 59(2) Annex X
15. Check if the implementation of a financial instrument continues across consecutive programming periods.	Art. 59(1) Art. 59(2) Art. 68(2)
16. Ensure that the eligibility rules defined in the funding agreement/strategy document are in line with the eligibility rules of the programme(s) priorities.	Art. 63
17. Verify whether the use of differentiated treatment of investors is in line with the investment strategy.	Art. 61
18. Verify that resources returned are re-used during the eligibility period according to the provisions of Article 62(1) CPR.	Art. 62(1)
19. In the final accounting year verify whether there are processes in place to manage the resources returned 8 years after the end of eligibility period.	Art. 62(2)

Other issues within the scope of an audit of the design and set-up of FIs include the consistency of eligibility rules in the Funding Agreement/Strategy Document and the programme, verification of any arrangements for differentiated treatment of investors and the re-use of resources returned.

fi-compass Knowledge Hub – Implementation of financial instruments across consecutive programming periods



The fi-compass Note of Workshop of this Knowledge Hub captures the best practice and experience of participants shared on the topic of this flexibility under Article 68(2) CPR. It includes a discussion about the implications of the Public Procurement Directive in relation to the amendment of existing Funding Agreements to enable FIs to continue into the 2021-2027 programming period.



06

Audits of operations: implementation of financial instruments

6.1 Eligibility

The 2021-2027 audit methodology sets out the different elements that need to be considered in relation to the eligibility of expenditure, having regard to the requirements of the CPR and the programmes agreed between the EC and managing authorities.

According to Article 68(1)(a), (b) and (c) CPR, the eligible expenditure of a financial instrument is the programme contribution provided to final recipients, i.e. the programme contribution disbursed to final recipients for loans and (quasi)equity, payments to or for the benefit of final recipients in the situation of combination with a grant component, and for guarantees the amounts committed in guarantee contracts for loans and (quasi)-equity effectively disbursed to final recipients.

Figure 5: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 20 - 21

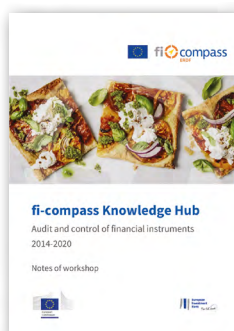
20. Check whether the final recipient is eligible according to the eligibility rules of the funding agreement/strategy document and the programme/priorities.	Art. 68
21. Verify that the selection of the final recipient was transparent and did not give rise to a conflict of interest.	Art. 59(7)

The checks of the eligibility of the final recipients are based on the eligibility requirements set forth in the programme or eligibility lists, eventually transposed into the Funding Agreement with the body implementing the FI.

Audit processes will typically seek to verify that final recipients meet the eligibility rules set out in the Funding Agreement for the FI, such as qualifying as an SME or meeting the criteria for buildings in an FI targeting energy efficiency. The verification of SME status and other eligibility criteria has been a key issue during the 2014-2020 programming period and participants commented that it is to be welcomed that the new audit methodology does not seek to change the established approach in this regard.



fi-compass Knowledge Hub – Audit and control of financial instruments 2014-2020



The Knowledge Hub Note published in 2020 on the 2014-2020 methodology considered in some depth how the eligibility of final recipients may be verified. This included the verification of SME status and alignment with the FI investment strategy.

The process to select final recipients should be verified to ensure transparency and avoidance of conflict of interest. Article 61 of the Financial Regulation defines conflict of interest, in relation to “family, emotional life, political or national affinity, economic interest or any other direct or indirect personal interest”. The Financial Regulation puts on national authorities the obligation to “take appropriate measures to prevent a conflict of interests from arising in the functions under their responsibility and to address situations which may objectively be perceived as a conflict of interests”.

Different verifications are needed in the case of implementation directly by the MA and in the case of an FI implemented under the responsibility of the managing authority. In fact, in case of implementation directly by the MA, the managing authority should have the adequate standards for selection of final recipients and procedures to prevent conflict of interest. In the case of an FI implemented under the responsibility of the managing authority whereby banks or other bodies implementing FIs are typically involved, the audit checklist clarifies that the usual business practices of the body implementing FIs should be applied to the programme contribution as it is applied to their own resources. The audit checklist emphasises that verifying that such usual business practices have been followed provides reasonable assurance that the selection of final recipients did not give rise to conflicts of interest. For example, if the financial institutions’ normal business practice consists in relying on self-declarations, the same would apply for FIs. Nevertheless, this should not prevent the managing authorities and auditors to perform management verifications and audits to check on a sample basis the veracity of those declarations, proportionate to the amount of public support and considering the available resources at disposal.

The Commission Guidance on the avoidance and management of conflicts of interest under the Financial Regulation of 09/04/2021 (2021/C 121/01), in chapter 6.3, explains that: “ As part of effective verifications to identify possible false declarations, all declarations should be (...) subject to checks (according to an appropriate methodology), in accordance with applicable law, against other sources of information to identify, for instance, links between those involved in the selection of projects and potential beneficiaries”.

Figure 6: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraph 22

<p>22. In case of support for investments (tangible or intangible assets) from financial instruments, check whether the investment (elements of the investment) was not physically completed or fully implemented at the date of the investment decision by the body implementing the financial instrument.</p>	<p>Art. 58(2) second sub-paragraph</p>
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The methods of verifying whether an investment (or element of investment) was not physically completed or fully implemented was discussed during the workshop. It was noted that the audit checklist highlights that a partially complete project can still be financed as long as the FI investment supports the elements that were not physically completed or fully implemented at the date of investment.



This issue may be verified by reference to the information submitted by the final recipient during the application process, for example: self-declarations by the applicant that the project is not completed, business plan (or equivalent) indicating the work to be undertaken or, where applicable, the findings of appraisal processes and/or third-party reports (such as a survey or energy audit). Participants discussed that in some cases, parties may wish to illustrate that the eligible expenditure was incurred after the investment decision or signature of the investment agreement, by reference to invoices to demonstrate the end of the finished part and the start of the implementation of the elements that were not physically completed or fully implemented.

The alignment of the support provided by the FI with its Investment Strategy, set out in the funding agreement/strategy document is also subject to review by the auditors.

Figure 7: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraph 24

<p>24. Check that the support through FIs comply with Fund-specific rules and eligibility rules of the funding agreement/strategy document and programme and priority.</p> <p>Obtain and analyse application forms or equivalent (including a business plan or equivalent documents and where relevant the previous annual accounts). Check that the investment decision corresponds to the main purpose of the requested investment.</p>	<p>Art. 59(7) Art. 63 Annex XIII, section II, point 6</p>
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The checklist describes how this can be verified by reference to application forms and other supporting documents such as, for example business plan or description of the investment. This is expected to be feasible for example to check if the transaction meets the eligibility criteria for an FI targeting energy efficiency or other specific criteria set forth in the Funding Agreement.

In general, this highlights the new emphasis in the audit approach on the ex-ante work undertaken by bodies implementing FIs. This recognises that the bodies implementing FIs have their own, ‘industry standard’ systems in place to subsequently monitor the financial performance of the loans or other investments. The checklist clarifies that whereas the purpose of the control under item 24 is to check if the documents exist and if the investment decision is in compliance with the eligibility rules, the auditor is not expected to re-perform the assessment of the loan application or of the investment decision.

During the workshop there was a discussion about the extent the auditors (and managing authorities) should take into account instances occurred after the investment agreement had been signed (e.g. that the resources were used for ineligible purposes). It was recognised that, of course, where a breach was identified concerning the eligibility rules, it would be necessary to take further action. This approach is part of the fundamental ‘risk-based approach’ inherent in all audit practices and aligned with the principle of ‘single audit and proportionality’ that underpins the 2021-2027 audit methodology. However, audit practices should avoid verifications that are not justified by the CPR rules and this audit methodology, contributing as such to “gold plating”.

Another topic of discussion was the observation that sometimes audit reports can be unhelpfully imprecise. To illustrate that, a case was shared within the group where an audit report indicated that a certain investment might not be 100% eligible without specifying how that conclusion had been reached (by reference for example to the legal base which was deemed not complied with) and without reference to the exact evidence on which the conclusion was based. For example, when auditors conclude that final recipients do not meet the criteria for SME definition, the finding has to be documented and justified in the audit report by reference to the exact conditions that were not met (e.g. staff numbers, annual turnover and annual balance sheet).



6.2 Verifying that support will be used for its intended purpose

One of the most important changes in the audit methodology for the 2021-2027 programming period is embedded in Annex XIII, section II, point 10. This requires that the audit trail for FIs includes:

‘evidence that the support provided through the financial instrument is to be used for its intended purpose’

In other words, this means that the CPR does not contain any requirement that the ‘use for intended purpose’ is verified or is possible to be verified (which was the case in 2014-2020⁴). The practical implication of the provisions in Annex XIII of the CPR consists in the fact that it does not require an obligation that the audit trail includes evidence that the support was used for its intended purpose.

Participants discussed how this seemingly small change actually has a large impact on the verification/audit of this issue, which has in the past been problematic in many Member States by creating an additional burden in terms of controls and audits. It is therefore a welcome development by the CPR to help simplifying the implementation of FIs. Participants commented that it should be ensured at Member State level that this approach is followed by the various entities involved in the implementation of FIs, including in the framework of their approach to audit of FIs.

Figure 8: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraph 25

25. Obtain evidence that the support provided through the financial instrument is to be used for its intended purpose.	Annex XIII, section II, point 10
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The 2021-2027 audit methodology takes a straightforward approach to the issue by aligning its requirements with the obligatory elements of the FI audit trail under Annex XIII CPR. This means that use for intended purpose will be verified by reference to applications for financing or equivalent and the investment decision.

Crucially, as the focus of the verification is the intended use of the support, invoices (which relate to subsequent expenditure) are NOT relevant to this question and therefore should not form part of this verification activity. It was agreed that bodies implementing FIs may still use invoices to support disbursement of funds, in line with their usual banking practices. However, this should be seen as a separate issue from the requirement under the CPR to ensure the FI audit trail includes evidence that resources will be used for the intended purpose. Notwithstanding this, further verifications might be deemed necessary in case of a specific risk of irregularity or a suspicion of fraud (including for example the veracity and reliability of the available documents).

This further emphasises the focus on the documentation collected during the application process ex-ante of the signature of the investment agreement with the final recipient. Participants broadly welcomed this as a simplification, but it was recognised that ‘normal banking practice’ will vary in relation to the detail of documentation required by banks or other bodies implementing FIs. For example, Fintech platforms typically do not require as much supporting documentation as more traditional financial institutions. Similarly, banks often relax requirements for documentation as part of an application process when dealing with existing customers.

This means that the Funding Agreement should clearly set out the structured application process and supporting documentation that will be required to support the FI audit trail according to Annex XIII CPR. This would normally be included in the Business Plan submitted by the body implementing the FIs and should emphasise how this information must be gathered ahead of the credit risk and assessment for support that will be undertaken by the body implementing FIs.

4 Article 9(1)(e)(xi) of Regulation 480/2014.



6.3 Management costs and fees

The 2021-2027 audit methodology focusses on verifying that the management costs and fees (MCF) are aligned with the requirements of Article 68(4)-(5) CPR.

Figure 9: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraph 23

<p>23. Check the compliance of the calculation and payment of management costs and fees with the funding agreement and if applicable, verify if the thresholds of Article 68(4) CPR are respected. Check that fees charged at final recipients are not declared as eligible expenditure.</p>	<p>Art. 68(4) Art. 68(5)</p>
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The compliance with the Funding Agreement is the key issue for the audit of MCF. Further, where the body implementing FIs is appointed through a direct award, the verification process should include the observance of the thresholds under Article 68(4) CPR.

Participants discussed to what extent reliance can be placed on review by external auditors in relation to this question. For example, if the body implementing FIs is required to have their MCF signed off by their external auditors, would this be sufficient for audit purposes? Managing authorities may outsource their management verification activities, which is permitted under Articles 81 and 83 CPR, subject to the third party being competent to carry out the work. In that context, having the MCF signed off by the bank’s auditor is a prudent measure as part of a management verification framework although the managing authority remains nevertheless responsible and accountable for the work.

This discussion highlighted the difference between management verifications and audit actions. The CPR provides at Article 81 that ‘the audit results of external auditors of bodies implementing the financial instrument may be taken into account by the audit authority for the purposes of the overall assurance,’ in relation to both system audits and audit of operations. The external audit can be relied upon as part of an audit of FIs as far as the CPR requirements for FIs fall within the audit scope of the external auditors and taking into the account internationally accepted auditing standards.

6.4 Audit of advance and the amounts clearing the advance

Two separate approaches are included in the 2021-2027 audit methodology for the audit of payments by the EC to managing authorities, reflecting the new provisions under Article 92 CPR. Participants commented that the simplified payment regime in the current programme period is a welcome development as the previous phased payments (tranches) under the 2014-2020 programme was complex and posed more difficulties and additional controls and verifications.

Under the 2021-2027 programming period, as the audit focus is on incurred expenditure, any legality and regularity issue might potentially trigger a financial impact to be mirrored in the error rate. The approach to auditing the advance under Article 92(2)(a) CPR is focussed on the requirement that the programme contribution (of up to 30% of the programme resources committed to the FI) must have been made to the body implementing the FI before the date of the payment application to the EC.



Figure 10: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 32 - 35

32. Verify that the advance is no more than 30% of the total amount of programme contributions committed to an FI. Verify that the payment of the programme contribution to the FI by the programme authorities was done before request of the first application for payment.	Art. 92(2)(a)
33. Verify that that the amount claimed in the first application was cleared by eligible expenditure disclosed in the Appendix 1 to the payment application.	Art. 92(2)(b) Annex XXIII/Appendix 1
34. Check that eligible expenditure declared to the Commission does not exceed the sum of the total amount of support from the Funds paid for the purposes of Article 68(1) and the corresponding national co-financing.	Art.68(6)
35. Verify whether the interest and other gains generated by the Funds were used for investments in or for the benefit of final recipients or management costs and fees.	Art. 60

In addition, by the end of the programme it is necessary to verify that this advance was cleared by eligible expenditure. The eligible expenditure in line with Article 68(1) CPR will be disclosed by the managing authority in Appendix 1 to the payment application (Annex XXIII CPR) as the advance is cleared by eligible expenditure.

In contrast, subsequent payment applications are based upon eligible expenditure incurred and the audit of such applications will be based on checks of the amount of expenditure paid (or set aside) in accordance with Article 68(1) CPR. The use of interest and other gains could also fall within the audit scope of FIs.

The audit methodology highlights that the verification of the payment applications to the Commission, including the (clearance of the) advance payment of up to 30% of programme contribution, imply a verification of the financial-flows between the managing authority and the bodies implementing the FIs (HF or SF in case of implementation without a HF) as well as between the body implementing SF and the final recipient and the respective MCF. It is a notable feature of this new process that, only incurred expenditure, i.e. individual transactions (i.e. loans disbursed, equity investments in final recipients) and MCF would be included in payment applications to the EC (with the exception of the first payment application).



07

Audit of operations: FIs combined with grants

The audit checklist includes questions related to both combination of FI and grant in a single operation and in separate operations. Where the FI is combined with a grant in a single operation, the 2021-2027 audit methodology applies to the audit of both the grant and FI components, in accordance with Article 58(5) CPR. In the case of combination in two operations, the methodology only applies to the FI operation.

For operations which combine an FI and grant in a single operation the first issue that may be considered is the ex-ante justification for the use of grant with the FI. Article 58(5) CPR requires that the grant should be 'directly linked and necessary' for the FI. The audit can review whether the justification has been documented before the implementation of the FI. The checklist refers to this being documented in the ex-ante assessment although it was clarified during the session that this is a matter of form only and the justification can also be in a separate document as long as it was prepared before the implementation.

Figure 11: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraphs 39 - 40

<p>39. In case of combination of support with grants in one single financial instrument operation, check that the rules applicable to financial instruments were applied.</p> <ul style="list-style-type: none">a. Verify that the ex-ante assessment contains a justification for the grant linked to the FI.b. Check and confirm that the allocation for the programme support in the form of grant does not exceed the value of the investments supported by the financial product.c. Check if separate records are kept for each form of support by the body implementing the FI.	<p>Art. 58(5) Art. 58(6)</p>
<p>40. Check that no ineligible VAT at the level of the investment was declared as eligible expenditure.</p>	<p>Art. 64(1)(c)(iii)</p>

During the meeting the feedback from the recent Knowledge Hub on combinations was discussed. One of the conclusions reached during the Knowledge Hub on combinations was reiterated, namely that the justification that grant is directly linked and necessary for the FI should be done at FI level and NOT in relation to specific investments.

Likewise, the requirement that the grant component does not exceed the value of investments supported by the financial product should be calculated at the level of the FI and NOT for individual investments. There was also some discussion about how 'the value of investments supported by the financial product' should be calculated. A simple example of a guarantee FI combined with a grant (notably capital rebate) was given to illustrate that the value of grants on a consolidated basis at FI level should not exceed the value of the investment financed by the guaranteed loans and not just the programme resources set aside to guarantee the investments.

Under point (d) of part 1 of Annex X to the CPR, the funding agreement should include provisions for monitoring the implementation of investments. The body implementing the FI and grant support in a single FI operation is expected to have a monitoring system in place that should ensure that the same expenditure item is not declared twice. When carrying out management verifications in accordance with Article 81(1) CPR and when carrying out system audits and audits of operations in accordance with Article 81(3) CPR, the managing authority and the audit authority respectively should be able to verify and audit the functioning of the monitoring system put in place by bodies implementing the FI.



Where FI support and a grant is combined in a single operation, the rules for FIs apply. The agreement(s) with the final recipient should define the conditions of financing, and what expenditure is to be supported by the FI/grant components or how much expenditure is to be attributed from the FI/grant components.

Once the combined FI/grant operation has been set up, the audit of operations may include verification that the proportion for grant support in Article 58(5) CPR is respected. The requirement that the grant does not exceed the value of investments supported by the financial product should apply no later than in the final accounting year, acknowledging that any shortfall mid-programme may be rectified towards the final accounting year (or an earlier accounting year if the FI is wound up earlier than the final accounting year). The checklist also provides for reviewing the keeping of separate records and observance of the rule under Article 64(1)(c)(iii) that allows irrecoverable VAT to be claimed as eligible expenditure when supported by grant in a combined operation in certain circumstances.

Figure 12: Extract from Audit checklist for auditing financial instruments, programming period 2021-2027, paragraph 41

<p>41. In case of combination of financial instruments with grants for the same expenditure item:</p> <ul style="list-style-type: none">a. Check whether the bodies implementing the FIs have in place procedures and controls to prevent double funding (the Fund's support under the FI was not declared to the Commission for support under another form/another Fund/another Union instrument.b. Check that the sum of all forms of combined support does not exceed the total amount of the expenditure item concerned.c. Confirm that the final recipient does not use the grant to reimburse the support received for the FI or that FI support is not used to pre-finance grants.	<p>Art. 58(4) Art. 58(7)</p>
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Paragraph 41 of the checklist applies to enable the audit to check that the rules in Article 58(7) have been observed regarding double declaration of FI support; i.e., the sum of the combined support should not exceed 100% of the expenditure item referred to in Article 58(7) CPR, the FI should not be used to prefinance grants and grants should not be used to reimburse support received from financial instrument.

Where FI support and a grant is combined in two separate operations, the grant agreement should specify how much of the total investment is financed through the grant and the related conditions and the loan agreement should specify the part of the investment financed through the loan which should take into account the grant component. For the grant operation, the verification and checks should be done based on grant rules.

It follows from Article 42(3) CPR that the managing authority (or the Member State) must provide cumulative data to the Commission in particular on eligible expenditure by type of financial product. The managing authority or AA should verify/audit that the respective amounts declared for the loan and the grant are consistent with the loan and the grant agreement.

When applying for support, the future final recipient/grantee may be required to communicate its previous support so that the grant agreement/investment agreement to be drawn up includes appropriate provisions that help reduce the risk of double funding.



fi-compass Knowledge Hub – Implementation of grants and financial instruments combined in a single operation



During this Knowledge Hub event, participants shared experiences and know-how on the topic of implementation of combined FI/grant in a single operation. The Note includes a discussion on how the justification that grant is directly linked and necessary to the FI can be made.

Participants engaged in a lively dialogue on the question of what should be counted to verify whether all forms of combined support do not exceed the total amount of expenditure item concerned. Participants shared their practice where they include both EU programme resources and national resources when assessing whether there has been any double declaration of FI support. It was acknowledged that this may be necessary where national rules require such an approach. However, strictly the requirement at Article 58(7) CPR relates only to the programme resources. This means that only EU resources fall to be considered in relation to compliance with the CPR. This can include financing from sources outside the Cohesion Policy resources such as the Horizon Europe programme but does not include additional national financing (over and above any national co-financing of the programme). However, the compliance with the principle of sound financial management could fall within the audit scope for FIs.

Other types of funding such as tax credits were also considered. An example was given where a project financed by an FI may enable the final recipient to qualify for a tax credit in the future (e.g. due to improved energy efficiency). Participants considered whether such benefit could be said to fall within the calculation of combined support. It was concluded that this was NOT the case. First, such funding would be outside the scope of EU programme support and second such support was not directly related to the project costs in delivering the project. As such it would fall outside the scope of Article 58(7) CPR. It was acknowledged that a tax credit may be relevant for other aspects of the implementation such as State aid but this fell outside the scope of the audit of double declaration of FI support.



08 Sampling

8.1 General considerations

The rules for sampling for the purposes of audit of operations in the 2021-2027 period can be found in the Sampling Regulation. The participants discussed the significant simplification in the new rules which reflects in part the simplified payments regime under Article 92 CPR.

Audits of operations should be carried out on the basis of expenditure declared per programme or group of programmes. There is no requirement of common management and control system. Furthermore, stratification remains as an option only. This means that FIs can be included in a single audit population alongside the grant operations under the same programme. Stratification to separate FI from grant operations should only be considered where it is deemed appropriate in the professional judgement of the audit authority.

The application of the same approach for grant and FI operations means that there are no special requirements for operations which combine FIs with grant. Such operations can be treated in the same way with no need for separation through stratification of the sample.

Furthermore, sampling may cover two programming periods (Art. 79 CPR) as long as the FIs and the related MCS are the same for the two periods, and there is a stratification which allows for proportionate controls covering each period.

8.2 The audit population

The audit population for FIs is made up of the advance and the eligible expenditure. However, to avoid double counting of eligible expenditure, the eligible expenditure used for clearance of the advance is excluded from the population for the purposes of the error rate calculation. This gives rise to a potential assurance gap unless additional audit activity was considered to include this part of the population.

Figure 4 Audit stages of FIs in 2021-2027 programme

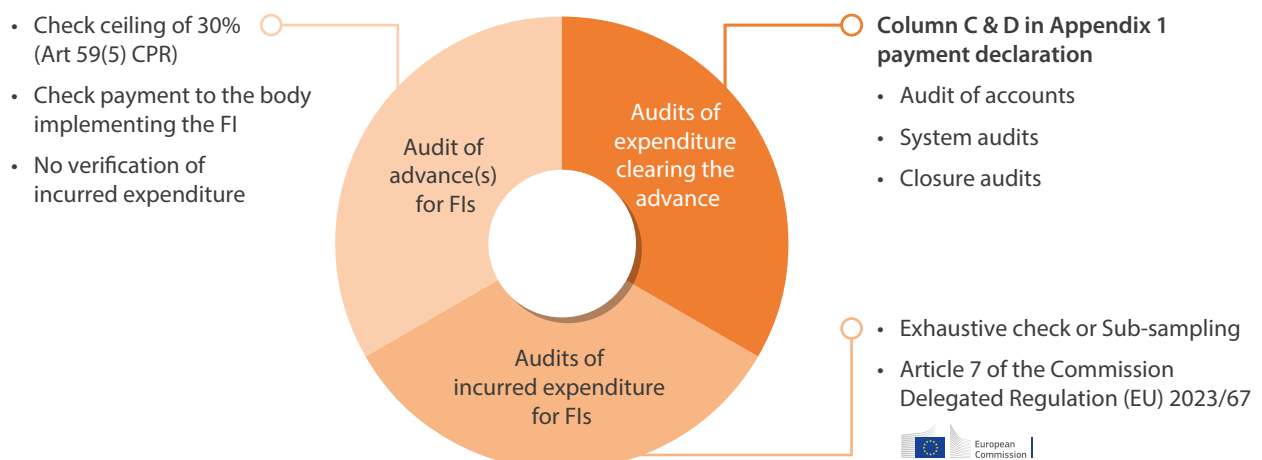


Figure 4 shows the three stages of audit of financial instruments. The first two stages, the audit of advance and eligible expenditure forms part of the audit population, whereas the third category, the audit of expenditure clearing the advance, is based on the expenditure reported in column C & D in Appendix 1 of the payment application. Audit authorities should include a proportionate process to ensure the potential assurance gap is addressed.



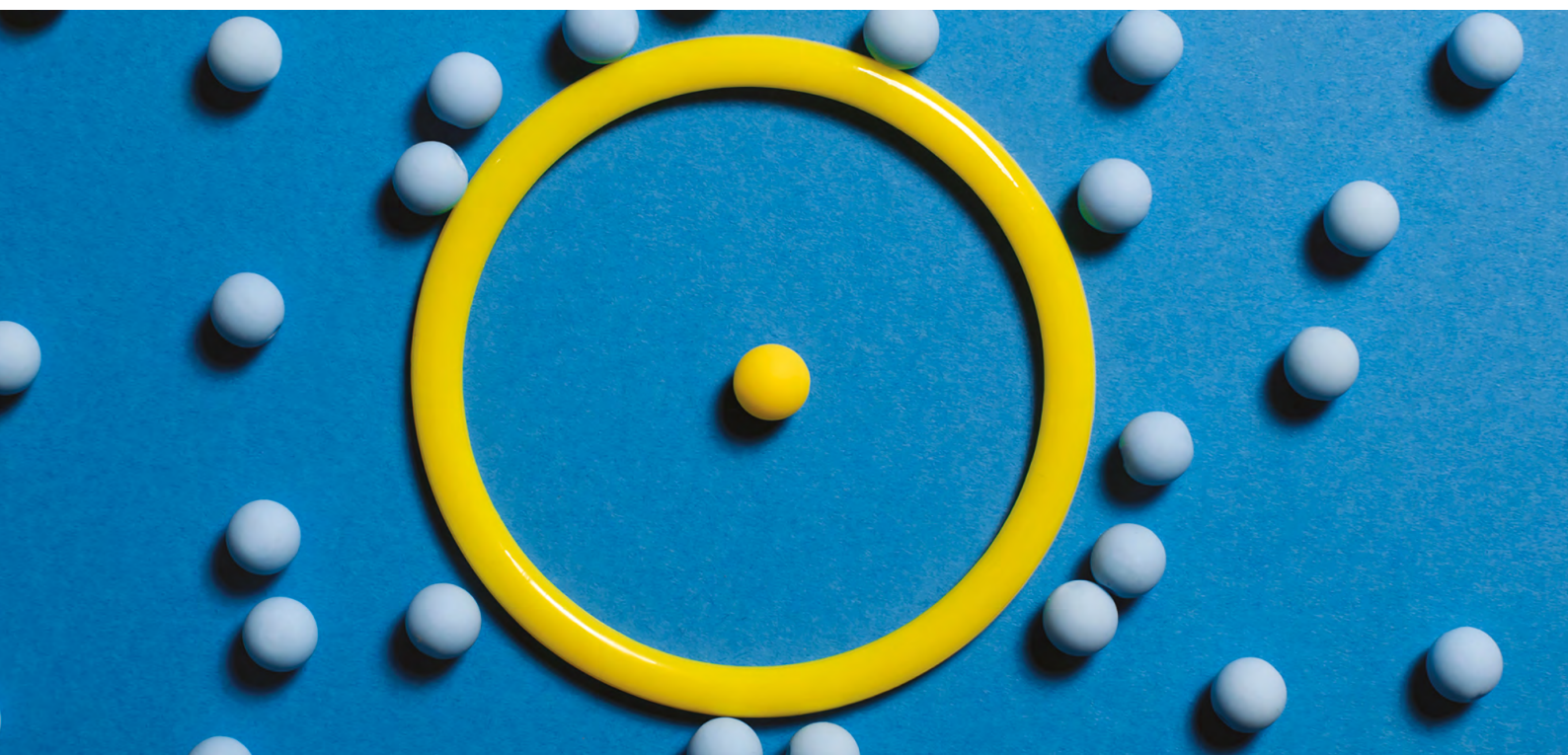
Final comments – laying the ground for the simplification of audit of FIs

Discussions during the Knowledge Hub highlighted the significant change in emphasis of the rules governing the audit of FIs in the CPR and the accompanying 2021-2027 audit methodology.

Some of the key topics that came out of the discussions that could potentially be deployed to save cost and reduce the burden on bodies implementing FIs included:

- The adoption of the principle of single audit and proportionality to avoid duplication of audit work and develop the cascade approach to audit;
- Well timed system audits to maximise the added value to the managing authority from such activities;
- The importance of the documentation submitted during the investment application/appraisal process and the reporting/audit trail from HF/SF to the managing authority;
- In particular, verifications based on evidence that support provided through the financial instrument is to be used for intended purpose. This approach should reduce the reliance for verification and audit on invoices and other documentation generated in the course of the on-going management of investments and thus reduce the burden on bodies implementing FIs and cost; and
- Relying on external audits of bodies implementing FIs where reasonable to do so.
- The simplified sampling methodology which does not require a stratification of FI operations.

These and other flexibilities create opportunities for audit authorities in consultation with managing authorities to develop robust audit plans that address some of the challenges that have been encountered by financial instrument practitioners at all levels in previous programming periods. Audit authorities are encouraged to streamline and to embrace the potential to simplify the audit of FIs thereby contributing to the continued successful development of this sustainable form on financing through EU shared management funds.



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