



**EUROPEAN COMMISSION**

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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
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 Parliament and of the Council	Standard terms and conditions for financial instruments  Templates for "off-the-shelf FIs
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/)

	<b>Publication date</b>
Financial Instruments – Overview of changes in Title IV of the CPR following the Omnibus Regulation	05.03.2019
Guidance for Member States on reporting on financial instruments (Article 46) and on leverage effect (Article 37(2)(c))	19.03.2019
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
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 for the audit of financial instruments (FI) operations co-financed by ESIF in the programming period 2014-2020, including an audit checklist (Annex 1), a sampling manual to the audit authorities (Annex 2), guidance on the verification of the use for intended purpose in case of working capital (Annex 3) and an overview of the management and control responsibilities (Annex 4). 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. 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 related to the nature of the FI operations and is relevant both for system audits and audits of 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 expenditure.

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.

There are 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, eligibility of management costs and fees including aspects of the selection of bodies implementing FI, including fund of funds if applicable, compliance with State aid rules, compliance with disbursement thresholds (Article 41 CPR), use of reflows.** All these risks are covered in the audit checklist in Annex I.

## 2. 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 the Delegated Regulation (EU) 480/2014, the audit authorities shall carry out system audits and audits of operations throughout the programming period. The audit work should be 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 (Article 40(3) CPR).

The scope of the audit work for system audits include an assessment of the controls carried out by the managing authority<sup>1</sup> 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 intermediaries<sup>2</sup> in respect of the relevant funding agreement. System audits focus on the functioning of the programme's management and control system and not on individual 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 credit institutions subject to financial supervision are regulated institutions.

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 instrument<sup>3</sup>. 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 select a representative sample of files from final recipients for the audit of operations in order to conclude on the compliance with the before mentioned Article.

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.

For FIs subject to phased applications for interim payments during the programming period, at closure the AA will have to provide assurance about the final total amount of eligible expenditure in line with Article 42 CPR taking into account all audit work performed during the 2014-2020 period. This audit will be outside of the regular sample for audits of operations, which is based on declared expenditure. It will cover the eligibility of expenditure related to the last tranche as well as up to 15% of the amounts included in the previous tranches not covered by previous audits of operations. Such audits to cover the remaining population of eligible expenditure not covered previously should be planned and the results of the audit

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<sup>1</sup> The list of controls performed at each level are presented in Annex 4.

<sup>2</sup> 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 2), the selection for the system audits should be risk based.

<sup>3</sup> Except for financial instruments implemented under Articles 38(1)(a) and 38(4)(d) of the CPR.

work reported under section 8 of the last annual control report<sup>4</sup>. For the sampling methodology, please refer in particular to section 5 of Annex 2.

We further recommend to disclose processes and procedures which constitute excess administrative burden and cost, or can be simplified without undermining the overall assurance and effectiveness of the management and control system. This concerns in particular practices in which FIs are managed in the same way as grants.

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

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

### **a. Set-up of the FI**

The audit work focuses on 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, but 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 not covered by a system audit, the audit work on the set-up may be performed at a later stage, with the audit work on the second and/or following tranches.

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### **b. Implementation of the FI**

The audit work focuses on two interrelated elements:

#### **Compliance with the conditions to claim a tranche**

A special attention is to be put on the payments and the compliance with the condition of achieving a certain level of eligible expenditure of the amount paid in the first or previous tranches in order to claim the second or following tranches.

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

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<sup>4</sup> Please consider also section 12.4.1 of the Guidelines on closure 2014-2020 (EGESIF EGESIF\_20-0012-01).

distribute the audit work throughout the programming period (as requested in Art 9.2 of Regulation 480/2014) and already identify issues, which can be remedied at that moment, including early replacement of ineligible expenditure. Such testing of related expenditure would also help to identify errors as early as possible and take mitigating actions in order to improve the system and ensure sufficient eligible expenditure at closure.

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) CPR.

A testing of a sample<sup>5</sup> of the underlying investments supporting the declaration of the expenditure to the Commission shall be carried out at the appropriate level (see Article 40 CPR). We recommend that the population<sup>6</sup> for the selection of a sample of files from final recipients is the declared investments to the MA (through normal reporting procedures) at the moment of the audit. In case of individual irregularities as defined in Article 2(36) CPR detected at the level of final recipients and/or management costs and fees, it should be concluded whether the payment of the tranche is legal and regular, i.e. compliant with Art. 41 CPR. If not, the auditors will consider if there is only a compliance issue<sup>7</sup> with the phased payment (threshold not reached) or whether the whole amount of the tranche 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 CPR 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, providing assurance on the eligibility of the underlying expenditure for the FI till that point of time. If the FI operation was already subject to previous audits by the AA, 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.

### **Verification of eligibility of expenditure**

The audits of operations at the level of the disbursed expenditure cover the i) eligibility of final recipients and their projects audited against the eligibility rules (eligible area, eligible

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<sup>5</sup> The methodology in Annex 2 aims at providing assurance on the totality of FI expenditure at closure. Any testing during the period contributes to this objective.

<sup>6</sup> The audit population can contain all investments/management costs and fees until the moment of the audit. The MA can provide to the AA the list of investments forming the audit population, independently of the stage of reporting this incurred expenditure to the EC within payment claims and of management verifications.

<sup>7</sup> A compliance issue means a tranche not meeting the conditions of Art. 41 CPR at a certain moment of time. There is a legal breach, as at the moment of declaration to the Commission this tranche was not eligible. However, if such a tranche would comply with the eligibility requirements at the moment of the audit of the financial instrument or at latest at the moment of the submission of the accounts, this error would not have an impact for the purposes of the total error rate calculation.



expenditure, SME status, State aid aspects, etc.) and the conditions of the investment decision, ii) the use for intended purpose as indicated in the funding agreement / business plan or equivalent document as well as iii) eligibility of management costs and fees.

- Verification of the use for intended purpose<sup>8</sup>

It is expected that the bodies implementing the FI are verifying the use for intended purpose based on the conditions set in the funding agreement.

The managing authority should have procedures and methodology to verify that the use for intended purpose was checked by the bodies implementing the FI. Such verifications are performed, as a general rule, based on the internal procedures of the financial intermediary supplemented by a sample of investments resulting from a risk assessment which is proportionate to the amount of public support and the risks identified.

The managing and audit authorities will consider the stage of implementation of the investment when verifying the use for intended purpose. In some cases, when the investment is not completed/not sufficiently advanced, the use for intended purpose may not be possible to be verified at the moment of the control/audit. The control/audit will then conclude on the eligibility of the investment based on the information/data available at that point of time.

More details on the scope of the controls to be carried out are provided in Annex 4, part referring to the controls performed by the AA, and for the specificities of working capital, not always disposing of probative documents, in Annex 3. However, the same approach is recommended for the MA verifications.

### **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 closure<sup>9</sup> are eligible.

For FIs subject to Article 41 CPR, the eligibility of expenditure 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 total 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. It is not necessary that all FIs are audited at closure, but each of them should have a chance to be selected. Furthermore, the AA may

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<sup>8</sup> Eligibility rules set at EU and national level are subject to audit for all ESIF expenditure, independently if it is related to FIs or to grants. The verification for intended purpose is specific for FIs. Therefore, we provide additional explanations on this aspect.

<sup>9</sup> Closure means either the closure of the instrument or the closure of the programme at the end of the programming period, whichever earlier.

decide to group the selected financial instruments for the purposes of their audits bearing in mind that then the results will be applicable to all financial instruments within the group.

The AA should carry out an audit of a statistical sample of investments and management costs and fees<sup>10</sup> for the eligible expenditure not covered in the framework of previous audits of operations. The AA could treat such expenditure as an additional sampling period in order to use the results of audits carried out previously (see example in Annex 2).

### **Replacement of irregularities after the submission of the closure documents**

As a rule, in the case of financial instruments, overbooking is not possible, i.e. to include in the final accounting year a certified amount exceeding that of the OP contribution which constitute the financial instrument and which is eligible expenditure in line with Article 42 CPR, since the eligible expenditure is any way capped to the maximum amount set out in the funding agreement and the approved budget of the FI operation.

However, the MA may set up the list of additional eligible investment to be used to replace irregularities identified after the submission of the closure documents. The replacement is only possible for individual irregularities under the condition that the managing authority ensures when submitting the closure documents that all following conditions are met:

a. the replacement is made with investments disbursed or committed for guarantees by the FI in final recipients and activities eligible under the operational programme by 31 December 2023 and made from:

- either resources recovered/repaid from illegal or irregular investments, or
- second and subsequent rounds of investments;

b. the investments used for replacement are fully compliant with all EU and national rules, including EU and national eligibility rules, operational programme provisions, funding agreement, and within the eligibility period of 2014-2020 programming period;

c. in a Fund of Funds structure, individual irregularities in a given FI may be replaced by investments in final recipients done by another FI in excess of the OP contribution transferred from the Fund of Funds, provided that the funding agreements and all other EU and national rules have been respected.

For the audits aimed at getting assurance at closure, when the AA establishes its audit population for the audited FIs of the investments/management costs and fees, the AA may include in its population also any such additional eligible investments. These additional investments should respect the rules for eligible expenditure for FI in accordance with Article

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<sup>10</sup> With regard to financial instruments set up under points (a) and (c) of Article 38(1) of the CPR and for financial instruments set up under point (b) of the same Article implemented by the European Investment Bank (EIB) or other international financial institution, management costs and fees charged by EIB/European Investment Fund (EIF) or by other international financial institution are audited by the external auditors of the EIB/EIF. Furthermore, any management costs and fees charged by the financial intermediaries selected at national level by EIF for loans and equity instruments are checked by the external auditors of EIB/EIF.

42 CPR and consequently subject to the same verification and control requirements as the rest of the expenditure.

In practice, the managing authority may prepare a list with all the investments considered eligible including those coming from resources recovered, returned and new capital restored by the Fund of Funds manager. The audit authority will carry out their audit work taking into account the investments included in the list and give the assurance accordingly.

As for the systemic irregularities, see clarifications in section 4.

## **d. Financial instruments implemented with REACT EU resources**

REACT EU resources may contribute to new or existing FI to provide support under the thematic objective set out in paragraph 9 of Article 92b CPR, ‘Fostering crisis repair in the context of the COVID-19 pandemic and its social consequences and preparing a green, digital and resilient recovery of the economy’. Implementation of such FI are subject to CPR rules on FI.

### **Contribution of REACT EU resources to the existing FI:**

- The new REACT EU priority(-ies) or programme(-s) may contribute to the existing FI, taking into account:
  - no review or update of ex-ante assessment in line with Article 25a(10) CPR,
  - for working capital support no business plans needed, no need for evidence allowing verification that the support provided through the financial instruments was used for its intended purpose according to Article 25a(11) CPR
  - The funding agreement(-s) should be respectively amended,
  - State aid and public procurement rules should be respected.
- For example, if REACT EU resources contribute to the existing FI set up with the ERDF programme resources and REACT EU resources have the same eligibility rules as the ERDF programme resources to provide loans:
  - Article 1 CIR 821/2014 applies to the programme contribution to the FI, meaning a separate account or an adequate accounting code applies to the contribution made by the programme with ERDF and REACT EU. However, it does not require financial intermediaries to maintain such accounting separation at its level, for example within the portfolio of loans it disburses and monitors.
  - For the applications for reimbursement by beneficiaries, the beneficiaries could decide independently or together with the managing authority the part of the request concerning ERDF programme resources and REACT EU resources.
  - At the level of each payment claim and at closure, the MA can therefore decide about the allocation of expenditure to the funding sources on a pro rata basis.
  - Another option is to use the sources of funding in a sequential way, for example, first ERDF and then REACT EU, to facilitate subsequent allocation of disbursed loans to their respective sources of funding.

- If the ERDF programme and REACT EU resources have different eligibility rules, then financial intermediaries would need to maintain an accounting separation in order to be able to precisely indicate to the MA, for reporting and audit purposes, which source of funding has been used for each loan. This separation may take the form of a separate account or a dedicated accounting code for the respective sources of funding.

#### **Contribution of REACT EU resources to new FI:**

Where MA are setting-up new FI, including with REACT EU resources, all the provisions of CPR in relation to FI apply, including ex-ante assessment, funding agreement(-s), etc. Article 25a(11) CPR remains applicable in case of support for working capital.

#### **Eligibility of expenditure irrespective whether the REACT EU resources contribute to the existing or new FI**

Expenditure is eligible for FI from 1 February 2020 if the underlying support to final recipients has been disbursed after the new funding agreement is signed or the existing funding agreement is amended to provide support under the thematic objective set out in paragraph 9 of Article 92b CPR.

Investments are eligible if they are in line with the types of actions that contribute to the objectives of the new priority axis(-es) or the new programme(-s) according to Article 92b(8).

Management costs and fees according to Article 42(1)(d) CPR are also eligible from 1 February 2020 only after the signature of the funding agreement or in case of the existing FI after the amendment of the respective funding agreement.

Once the OP is modified with the new priority axis(-es)/or the new OP approved, the national authorities can submit the payment claims according to Article 41 CPR.

AAs should carry the audits and controls as for any other ESIF programme resources contributing to FI and provide the necessary assurance for eligibility of expenditure at closure. All the steps described in the audit methodology are applicable to REACT EU resources when contributing to FI.

### **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 CPR 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 Act<sup>11</sup> 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 provide reasonable assurance on the set-up and effectiveness of the internal control system put in place by the EIB or other international financial institutions.

- The amended Article 40 CPR 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 may 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 CPR 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.

In the specific case of SME Initiative programmes for which the funding agreement was signed before Omnibus Regulation entered into force, there is no legal obligation for the national authorities to perform controls (Article 40(2a) CPR). However, the programmes remain under the responsibility of the national authorities. There is a risk of net financial corrections in case of irregularities identified later by the Commission audit services or by the European Court of Auditors. Therefore, the Commission strongly recommends the managing and audit authorities to perform controls at the level of the financial intermediaries, at least on a sample of investments/projects of final recipients<sup>12</sup>. Alternatively, upon request EIF may also agree to provide the necessary documentation to the national authorities.

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<sup>11</sup> Commission Implementing Regulation (EU) 2019/1140

<sup>12</sup> For example, see chapter 6 of Annex II for a simplified method for audits of operations.

## 4. Treatment of irregularities in financial instruments

Legal references:

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.*

### **Treatment of irregularities**

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 mechanism reducing the risks of the FI operations.

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, in a single FI any contribution cancelled due to an **individual irregularity** identified during audits and controls cannot be reused for other eligible expenditure of the same body at which level the irregularity was identified. More specifically:

- Where the irregularities that give rise to the cancellation of the contribution occur at the level of the body implementing the FoF, the contribution cancelled cannot be reused for the same FI operation. The concerned amounts programme contribution can be reused in the programme for other financial instrument operations or for grants.
- Where the irregularities that give rise to the cancellation of the contribution occur at the level of the financial intermediary, the contribution cancelled cannot be reused for the same financial intermediary but may be reused only for other financial intermediaries, if any, and
- Where the irregularities that give rise to the cancellation of the contribution occur at the level of a final recipient, the contribution cancelled cannot be reused for the same final recipient but may be reused for other final recipients within the same financial instrument.

In case there are **systemic irregularities**<sup>13</sup> 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. Such irregularities will have a significant impact on the FI. In most cases, they may originate from systemic weakness at the level of the fund manager and/or impossibility to implement the FI fully or partially. The AA (or the external auditor in case of EIB/EIF) has to confirm on the improvement, i.e. that the bodies function properly and that the irregular expenditure has been deducted from the total amount of eligible expenditure incurred. If the system cannot be improved anymore, i.e. in case all funds have already been disbursed, and in line with the above Article 40(5a) of the CPR, the contribution cannot be reused for the same FI. Those irregularities will as well lead to a reduction of the ESI Funds programme allocation to the concerned FI but can be reused in the programme for other FIs or grants<sup>14</sup>.

All irregularities should be clearly described in the Annual Control Report of the year when they are established and be subject of subsequent follow-up by 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.

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<sup>13</sup> Art. 2 (38) CPR states: “systemic irregularity” means any irregularity, which may be of a recurring nature, with a high probability of occurrence in a similar types of operations, **which results from a serious deficiency in the functioning of a management and control system**, including a failure to establish appropriate procedures in accordance with this Regulation and the Fund-specific rules

<sup>14</sup> Except for SME initiative programmes, where the reduced amount cannot be reused and will be a net reduction to the amounts allocated to the programme.

The (interim) payment application, appendix 1 (columns C and D) and appendix 6 (columns C and D) of the accounts are cumulative. Therefore, the amounts reported must be updated in each report and reflect the amounts adjusted for deductions of incurred expenditure applied based on all verifications and audits. At programme closure, columns A and B of the above two appendices should be equal to columns C and D. In case, there is no such full implementation (independently if due to irregularities or performance), the reduction of the amount vis-à-vis the EU budget is done at closure as well. If the FI was underperforming during the programme implementation, the programme resources should have been reallocated to other operations in the programme and not left until closure.

### **Compliance with the threshold for payment of the second and following tranches (Article 41(1)(c) CPR)**

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 annual 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, it should draw conclusions on the functioning of the FIs in the programme and describe it in the ACR. In some cases, additional audit work might be considered. The error should be added to the total error rate for the accounting year in which the tranche was declared to the Commission. The MA/CA should deduct the amount from the accounts. The withdrawal of the tranche should be included in the corrections performed for the calculation of the residual total error rate



(value H). 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, i.e. the threshold of 60% or respectively 85% of eligible disbursed expenditure is reached.

The finding will be considered for the audit opinion on the legality and regularity of the expenditure in the accounts. In the cases where the TER exceeds the materiality level due to the non-compliance of the tranche(s) with Article 41(1)(c) CPR, the AA should describe this in the ACR clearly indicating that any actions to be undertaken to correct and improve the functioning of the management and control systems concern the expenditure for FIs<sup>15</sup>.

- 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 non-financial 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 their follow-up and will reflect such findings 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 investments in working capital**

### **Annex 4 Management and control responsibilities**

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<sup>15</sup> As the implementation/expenditure declaration requirements and the risks are different, errors of non-compliant FI tranches should not be projected to grants. However, the AA should analyse if there is a risk for a similar error in other non-audited FIs (if applicable) and decide if additional work/controls are needed.