European Investment Bank

AUDIT COMMITTEE

Annual Report to the Board of Governors

For the 2004 financial year

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

For the 2004 financial year

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1. INTRODUCTION

The statutory role of the EIB's Audit Committee is to verify that the Bank's operations have been conducted and its books kept in a proper manner.

The Audit Committee's core duties are to oversee the work performed by the external auditors and to ensure co-ordination of such work with that of the internal auditors, to safeguard the independence and integrity of the audit functions, to follow-up on audit recommendations and to understand and monitor how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration. Moreover, the Committee must establish whether the financial statements, as well as any other financial information contained in the annual accounts drawn up by the Board of Directors give a true and fair view of the financial position of the Bank in respect of its assets and liabilities, and of the results of its operations and its cash flows for the financial year under review. It shall provide the same confirmation in respect of the consolidated version of the financial statements.

The annual report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities during the past year. It covers the financial year 2004 as far as the Audit Committee's opinion on the Bank's financial statements is concerned. For other aspects, it covers the period since the last Board of Governors' meeting. A separate summary report of the Audit Committee's activities in respect of the Investment Facility is annexed to this report.

2. DEVELOPMENTS WITHIN THE BANK

2.1. Developments in the Bank's activities

The Audit Committee noted a number of developments that may impact on its work in some respect, and has followed up matters identified in the 2003 Annual Report of the Audit Committee. The key findings are reported below:

<u>Accession and associated audit requirements</u>: The contribution of the new Member States to the Bank's capital, reserves and provisions, comprising the balance of the profit and loss account was determined as at 30 April 2004. The Bank established its unconsolidated financial statements at this date and, in accordance with the discharge procedures for the financial statements of the Bank, the *Audit Committee* agreed to the financial statements as supported by the associated report of the external auditors.

<u>Investment Facility:</u> Within the framework of the Cotonou Agreement (which succeeds the Lomé Convention), the Bank manages Members States' resources under the Investment Facility as well as associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). Operations within the Investment Facility officially started on 1 April 2003. The *Audit Committee* has since monitored the activities of the Facility, and signed a statement regarding the 2004 financial statements, related to the Facility. The *Audit Committee* supports the Bank's proposals for ring-fencing of the Investment Facility management to allow clear identification of expenditure and remuneration in 2005.

<u>Facility for Euro-Mediterranean Investment and Partnership (FEMIP):</u> Further to the ECOFIN Council decision of December 2003, FEMIP was "reinforced" in 2004 through the introduction of the following new features and activities (which have already been implemented):

(i) a "Special FEMIP Envelope" (SFE) to enhance private sector lending;
(ii) a FEMIP Trust Fund, funded by member states, financing upstream technical assistance activities and risk capital operations in the region and requiring separate accounts, reporting and audits;
(iii) the introduction of a FEMIP annual Ministerial meeting to be prepared by two High Experts Committees meetings;
(iv) the opening of a local office in Tunis (followed by the opening of another FEMIP local office in Rabat in May 2005).

In 2004, Bank Management identified a number of significant areas for improvement related to procedures and reporting related to the EC-funded Risk Capital Facility in the Mediterranean. In particular, the levels of monitoring applied to earlier mandates for operations in the Mediterranean should be strengthened in the context of the FEMIP operations. The *Audit Committee* supports the actions taken and planned in respect of the management of risk capital operations within FEMIP.

The *Audit Committee* acknowledges its responsibility for verifying proper monitoring of the activities of the FEMIP Trust Fund and for signing a statement regarding the 2005 and future financial statements relating to the Fund.

Foreign exchange opportunity losses: In 2004, the Bank experienced unexpected outturns (with limited financial impact) in respect of a small number of foreign exchange exposures that were not reported correctly or hedged in a timely fashion. The *Audit Committee* is satisfied that the Bank responded appropriately to such instances by involving Internal Audit to investigate the circumstances of situations, renegotiating certain agreements and by making improvements in reporting controls and clarifications in responsibilities.

2004 borrowing from 2005: The 2005 borrowing programme within the Corporate Operational Plan (COP) 2005-2007 has a global borrowing authorisation of EUR 50bn. A share of EUR 5bn from the 2005 borrowing programme was approved for use in 2004 (2003: EUR 5bn) by the Board of Directors, subject to favourable conditions being available on the capital markets for different types of operation.

Loan Portfolio Quality: The Bank has made further improvements in the reporting of credit risks through use of, for example, sophisticated concentration measures based on Credit Value-at-Risk, which better describe risk correlations in the loan portfolio. The *Audit Committee* has reviewed each of the Bank's quarterly reports on credit risk and notes that overall credit quality of the EU loan portfolio, as quantified by the distribution of loan gradings, has remained high. The distribution of loan grading of the year-end stocks of loans establishes the level of the year-end Fund for General Banking Risks (FGBR) due to general lending risks. The FGBR has reduced by EUR 135m compared to the 2003 year-end figure, essentially due to the Accession of the new ten Member States that are no longer subject to the Pre-Accession provisioning rate of 1% as applied in 2003. However, without this effect, there would have been an addition to the FGBR of approximately EUR 25m. The *Audit Committee* notes that the Bank's has decided to increase the provisions for specific loans based on objective evidence of risk of non-recovery.

2.2. Significant measures taken by the Bank

From the Audit Committee's perspective, significant measures have been taken by the Bank to respond to the changing environment and to manage the risks arising from trends in its activities:

Achievement of Objectives: The Bank's institutional objectives for 2004 were to contribute to EU policy goals through Priority Lending Operations, Value-Added and increased Transparency/Accountability. The Bank also set targets for meeting customer expectations, financial performance and for providing an appropriate internal structure and associated processes to support the Bank's activities. The Bank's performance is measured in terms of Key Performance Indicators which were defined in the Corporate Operational Plan 2004-2006 (and were approved by the Board of Directors in that context) [1].

The *Audit Committee* has been regularly updated on the Bank's progress towards the 2004 targets set for each of the above objectives, and the *Committee* notes that the Bank achieved more than 95% of all targets, and has exceeded the targets set in a number of areas.

The new Corporate Operational Plan (COP) 2005-2007 was approved in December 2004. The COP has been established following the accession of ten new Member States and at a time of review of the Bank's institutional objectives. The Bank intends to (a) intensify its focus on the main pillars of its strategy to highlight the consistency of the lending activity with the priority objectives of the EU by focusing on added value and (b) to continue to adjust policies and practices regarding corporate governance, including transparency and risk management. In respect of corporate governance, the Bank is adopting measures that take account of its dual role as a financial institution and as a European body serving the policies of the EU. The budget for 2005 provides additional resources for specific items linked with the Bank's lending operations.

[1] Other core performance indicators were also presented in the Corporate Operational Plan 2004-2006.

Accountability and Transparency: In recent years, the Governors of the Bank have reinforced the Bank's role as a public policy-driven bank. The Bank has responded to the increasing demand for democratic accountability of European institutions by developing a constructive dialogue with the European Parliament, particularly its Economic and Monetary Affairs Committee (EMAC), on the support provided by the Bank to various EU policies. The successive EMAC reports that have been issued over the years have helped the Bank to progress on the line of political orientations given by the European Parliament. Specific actions taken in 2004 include:

- the publication of the Bank's Transparency Policy (and associated action plans) and the first annual Statement on Governance;
- the disclosure of professional and financial interests of the members of the Management Committee; and
- the disclosure of the Curriculum Vitae of the members of the Board of Directors and Audit Committee (with a view to raise transparency and accountability in relation to possible conflicts of interest).

The *Audit Committee* notes that a number of press articles in 2004/2005 called for even greater transparency within the Bank. Nevertheless, the *Audit Committee* welcomes the progress in respect of public disclosure made and planned by the Bank.

Compliance function: In order to enhance the EIB Group's function dealing with compliance aspects and in conformity with the Basel Committee Guidelines, the Bank is currently seeking to recruit a Chief Compliance Officer to assess, advise on, monitor and report on the EIB Group's compliance risk. Specifically, consideration will be given to the risk of legal or regulatory sanctions, financial loss, or loss of reputation that the Bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice. The work shall also take into account the EIB's particular status as a financial institution and as a European Union body. The *Committee* encourages the Bank in this important step forward, particularly as in its 2003 Annual Report, the *Audit Committee* identified the area of compliance with laws, regulations and published internal procedures as of increasing interest and relevance to its work.

Risk Management Policies, Procedures and Reporting: In November 2003, the Bank implemented a reorganisation of its risk management functions, and brought Credit, Asset and Liability Management (ALM), Market and Operational risks under a unified responsibility within the new and independent Risk Management (RM) Directorate. In 2004/2005, this measure has led to:

- *Revised Risk Policy Guidelines:* A number of changes have been made, the key ones are summarised below:
    - Credit Risk Policy updates in respect of: new eligibility requirements for bank loans , the Special FEMIP Envelope; the limit system for Minimum Acceptable Criteria (MinAC) operations and Single Signature Single Risk bank sub-limits
    - New Financial Risk and ALM Policy Guidelines (FRPG) were issued in December 2004 and a number of new risk policies emerged, in particular, guidelines for structured and new capital markets transactions, and new rules relative to the management of risks implied by structured borrowings or issues on new capital markets (which establishes most notably, the rules for the fair value assessment of these new transactions) and a new foreign exchange risk policy on future margins from loans. The FRPG also establish the generalisation of opinions produced by the Risk Management Directorate, independently from the operational units, on the policy documents relative to borrowings and Treasury as well as on certain operations above the delegation limit provided to the Finance Directorate by the Management Committee.

- *Basel II compliance analysis* – Even though the Bank is not subject to external supervision, it voluntarily observes and applies main EU banking regulations and market "best practices". Following the issuance, in June 2004, of "The revised framework for international convergence of Capital Measurement and Capital Standards" by the Basel Committee on Banking Supervision ("New Basel Accord" or "Basel II"), the Bank has initiated work to articulate the consequences for the Bank of its possible implementation.

- *The creation of a Modelling Committee* to support the work of the New Products Committee, by analysing the methodological aspects of the development of asset valuation and pricing models.

- *A new reporting framework* with a more comprehensive format, including credit, financial and operational risks and the associated responsibilities, policies, assessment methodologies and disclosure requirements.

Risk Management Reporting: The *Audit Committee* has reviewed the various reports on risk management issues in the EIB and welcomes the improved explanations and presentation of risk considerations. The key matters reported are consistent with the *Committee's* understanding of significant risk aspects.

In respect of the Bank-identified slippages in control procedures during 2003 and 2004 and reported in the Annual Reports of the Audit Committee, the *Committee* recognizes that such issues may appear to be increasing because the effectiveness of reporting has improved, not necessarily because there may be a weakening of controls or performance. The *Committe*e is persuaded that the quality of the Bank's reporting of risk events has improved as identified elsewhere in this report, but nevertheless the *Committee* continues to seek suitable assurance of progress being made to contain the number and importance of such slippages.

Project and Operations Monitoring covers the follow-up of projects during implementation and of counterparties (promoters, borrowers and guarantors) after loan signature and up to full loan repayment. On 1 January 2005, revised procedures were introduced to address known weaknesses in monitoring, particularly in respect of definitions for *Project Monitoring*: monitoring of the operation at the level of the individual project which is split into physical monitoring and financial monitoring and for *Counterparty Monitoring*: financial follow-up and financial reviews of borrowers and guarantors (the counterparties) involved in one or several projects. The procedures also establish a clear split of responsibilities. Since 2001, the *Audit Committee* has noted that several audit reports have highlighted issues in monitoring procedures and therefore the *Audit Committee* supports the progress made. The *Audit Committee* will request frequent reports from the Bank regarding the effectiveness and efficiency of the procedures in practice particularly as it is noted that some monitoring procedures are planned to be phased into operation over a number of years.

Travel rules: Each year more than 6000 trips on professional grounds are made throughout the world to develop the Bank's business, and to represent its interests and hence those of the entire European Union. With the further enlargement of the Union and the new mandates handed to the Bank, the need to travel will not decrease and arrangements are likely to grow more complex. In June 2004, the Bank revised its travel policies which apply to all persons travelling on behalf of, or for the account of, the Bank regardless of grade or geographical location. The *Audit Committee* supports managements' view that the revised policies will contribute to greater rationalisation of official EIB travel in an economic environment increasingly calling for cost discipline.

Procurement Guides: In February 2004, the Bank revised the Guide to Procurement used to inform the promoters of a project (whose contracts are financed in whole or in part by the Bank, or are financed under loans guaranteed by the Bank), of the arrangements to be made for procuring works, goods and services required for the project. The Guide applies specifically to those components of a project identified for Bank's financing. However, in order to ensure overall feasibility of the project, the Bank requires that procurement of the other project components does not compromise the project's technical, economic and financial viability.

In early 2005, the Bank also published a revised Guide to Procurement for supplies, services and works for internal EIB purposes which explains how, as a Community body, the Bank acts in compliance with Community law on public procurement.

The *Audit Committee* welcomes the revised Guides to Procurement and supports the Bank's proactive approach to improve clarity in its procurement cycles.

IT Strategy: the Bank continues its ISIS information systems programme which commenced in 2000 with the upgrade of its IT infrastructure (completed in 2002) followed by implementation of a series of new IT applications which has continued in 2004/2005. ISIS was an ambitious multi-annual programme to renew a major part of the Bank's information systems and infrastructure. As the ISIS programme draws to a close, the *Audit Committee* will request an assessment of the efficiency and effectiveness of the investment.

The *Audit Committee* notes that the Bank has redefined its future IT Strategy to complement the guidelines and objectives set out in the Corporate Operational Plan 2005-2007. The Strategy focuses on containment of the Bank's IT expenditure, systems security and availability, IT expertise and on the provision of end-to-end IT processes, involving user and IT staff. In parallel to the IT Strategy, the

Bank has implemented an IT Governance model involving a cascading set of committees comprising both users and IT staff for IT-related decision making purposes and for defining accountability and responsibility.

2.3. Specific measures taken by the Audit Committee

The Audit Committee has also taken some specific measures related to its own roles and responsibilities. The key measures are summarised below:

Rules of Procedure Changes: In accordance with the Rules of Procedure which became effective on 1 May 2004, the number of Audit Committee observers has increased and in 2004/2005, the *Committee* successfully started integrating the new Committee representatives. The Rules of Procedures also make reference to the rotation of Audit Committee members and observers. The *Audit Committee* continues to rely on the selection procedures applied by the Board of Governors to ensure that new members and observers have appropriate independence, competence, integrity and expertise as stated in the Rules of Procedure. The *Audit Committee* has welcomed the Bank's support to ensure that all members and observers understand and can demonstrate a knowledge and interpretation of the Bank's activities and of the Audit Committee's roles and responsibilities.

External Audit Re-tender: A contract for external audit services with Ernst & Young, Luxembourg commenced 1 January 1997 and will expire when final signoff of the financial statements for the year ending 31 December 2004 takes place. In 2004, one of the key activities undertaken by the *Audit Committee* was the selection of an external auditor for a four-year period commencing 1 January 2005. The incumbent audit company was permitted to compete for the contract as no legal reasons existed to the contrary and also in order to ensure that appropriate competition was available. The *Audit Committee* is satisfied that the procurement procedure approved by itself and the Management Committee was appropriately observed during this process which resulted in Ernst & Young being re-selected. Each member of the Audit Committee evaluated the tenders received and the decision was made based on the cumulative points awarded to each tenderer under the award criteria defined in the procurement procedure.

The *Audit Committee* acknowledges that the Management Committee would have preferred a change of auditors because of possible external perceptions regarding independence of long-serving auditors and in line with international trends to make frequent rotation. However, the *Audit Committee* notes that Ernst & Young had declared that it would make an effective and appropriate rotation of key partners if reappointed (which would mitigate the threat of independence with senior Bank staff and the Management Committee), and that this has been effectively implemented. The *Audit Committee* considers that the threat to auditor independence from the *Audit Committee* members/observers is also mitigated because of regular rotation within the *Audit Committee* in accordance with the Rules of Procedure.

A revised Manual of the Audit Committee was approved by the *Audit Committee* in early 2005 to take account of roles and objectives stated within the revised Statute and Rules of Procedure[2]. The most significant changes relate to the following:

- Recognition of the July 2003 ruling of the EC Court of Justice on the relation between the Bank and the European Anti-Fraud Office (OLAF) and the associated legal framework which confirms the Bank's practice of full cooperation with OLAF;
- Reference to the Tripartite Agreement between the European Commission, the Court of Auditors and the European Investment Bank as revised October 2003;
- Updated interpretations of the Audit Committee's responsibilities in respect of:
  - Internal control and risk management;
  - Compliance of the operations of the Bank with the legal and regulatory framework;
  - Accounting and financial reporting;
  - Working with auditors (external and internal); and
  - Reporting responsibilities.
- Provision such that occupations or relationships which may be perceived to impair an Audit Committee members/observers independence shall be declared in order to allow judgement on whether the matter should preclude membership of the Committee;

[2] The previous Manual of the Audit Committee was dated 17 October 1997.

- o Formalisation of a procedure by which any matters which require Audit Committee attention, and which arise within the Bank between the meetings of the Audit Committee, can be dealt with; and
- o Confirmation that the Audit Committee has also adopted the Travel Policy (revised 2004) as adopted for the Bank staff, Management Committee and Board of Directors.

Audit Committee Charter: The *Audit Committee* considers that the revised Statute, Rules of Procedure and Manual are suitable to reflect current policies, missions and working practices of the *Audit Committee*. As a result, the *Audit Committee* considers that a separate Audit Committee Charter, (recommended as good practice in some major jurisdictions[3]) is not required.

Communications with the Bank and the external auditors: In its 2003 Annual Report, the *Audit Committee* acknowledged that the Bank's business and industry sector was changing more rapidly than ever. The changes will continue. In response, during 2004, the *Audit Committee* adopted more formal methods to communicate its expectations of both management and auditors to ensure its duties could and can be fulfilled. In addition to the information typically received by the *Audit Committee*, the *Audit Committee* has sought and received satisfactory information from the Bank's legal department on:

- the Bank's processes which ensure that an appropriate level of review of the effectiveness of the system for monitoring compliance with laws, regulations and published internal procedures and the results of managements investigation and follow up of any fraudulent acts or non-compliance can be facilitated;
- the applicability of the Sarbanes Oxley Act 2002 to the Bank[4]; and
- the liability position of members of the Audit Committee and, by extension, the Bank's statutory and decision making bodies.

The *Audit Committee* has also sought specific detailed information from the external auditors on:

- International Financial Reporting Standards and the impact of changes on the EIB Group's financial statements;
- Valuation of Venture Capital investments.

3. REVIEW OF AUDIT WORK

The Audit Committee held seven meetings in the year 2004. During those meetings, the Audit Committee regularly reviewed the work of the external and internal auditors. The Committee also maintained contacts with the European Court of Auditors.

3.1. External auditors

The Audit Committee reviewed the scope of the external auditors' work and concurred with the emphasis placed by the auditors on IT systems, valuation of structured products and financial instruments and Risk Management functions for market risk monitoring; the development of specific investment facilities (Investment Facility and FEMIP), foreign exchange hedging of loan margins and compliance with new or revised International Financial Reporting Standards (IFRS). The Committee examined the various reports produced by Ernst & Young and, during private meetings, discussed any other matters of importance with the external auditors.

The Audit Committee also performed the checks it deemed necessary to ensure the independence of the External Auditors.

3.2. Evaluation and Internal Audit

In February 2005, the Internal Audit and the Evaluation Departments were combined to form a single, autonomous department. The Inspector General, Head of Department is responsible for consultation, liaison and cooperation with the Audit Committee and external bodies in accordance with the Charter

[3] Securities and Exchange Commission (SEC) (in response to new rules proposed and adopted by the New York Stock Exchange (NYSE) and the Nasdaq Stock Market, Inc. (NASDAQ) requiring strengthening of their corporate governance listing standards, November 2003)

[4] The Bank's Legal department has concluded that there is a clear indication from the SEC that it does not consider that the Sarbanes Oxley Act is applicable to form 18-K filers such as the Bank.

for Internal Audit and the Terms of Reference for Evaluations. The *Audit Committee* particularly supports the promotion of the position of Internal Audit within the Bank.

The *Audit Committee* reviews and discusses each of the Internal Audit/ICF reports produced. Overall, the *Audit Committee* is satisfied with the Bank's responses to internal (and external) audit recommendations.

As previously reported, the *Committee* considers the concept of the ICF exercises as useful to provide assurance on the efficiency and effectiveness of the internal controls. The *Committee* has been informed that the main processes of the Bank are covered by ICFs and it will continue to monitor the implementation of ICFs in the remaining important areas. The introduction of ICFs commenced in 1999 and therefore the *Committee* also seeks assurance that ICFs are updated according to changes in business activities and as new application systems are implemented.

Internal Audit remains responsible for co-ordinating investigations into cases of alleged wrongdoing. Its work is designed to (i) inform management of any allegations of fraud within the Bank or within projects financed by the Bank, (ii) provide information about the fraud to enable appropriate actions to be taken and (iii) to inform and co-operate with the European Anti-Fraud Office as required. The status of cases of alleged wrongdoing is regularly reported to, and discussed by the *Audit Committee*.

The *Audit Committee* has received and will continue to seek regular assurance that the Internal Audit work programme is being executed and that audit resources are maintained at an adequate level. The *Audit Committee* was consulted on the drafting of the Internal Audit/ ICF work programme for 2005-2006.

The Evaluations division carries out *ex post* evaluations and coordinates the self-evaluation process in the Bank. It ensures transparency vis-à-vis the EIB's governing bodies as well as interested outside parties, by carrying out thematic, sector and regional / country evaluations of projects financed by the Bank, once they have been completed. Through its work, this division familiarises external observers with the performance of the Bank and through feedback to the Bank on a variety of aspects related to projects implemented, encourages the Bank to learn from experience. The *Audit Committee* has received copies of all Evaluations reports published in 2004.

3.3. European Anti-Fraud Office (OLAF)

In July 2003, the Court of Justice of the European Communities gave a ruling which provided the Bank with a legal framework for continuing its full cooperation with the European Anti-Fraud Office (OLAF), the EU's specialised body in combating fraud and corruption.

The *Audit Committee* has been assured by Bank management that OLAF has continued to be notified (at the same time at which the Committee is informed of such cases) of all Bank-initiated investigations into cases of alleged wrongdoing, and periodically of the status thereof. The *Audit Committee* is also appraised of joint Bank-OLAF investigations. The *Audit Committee* considers that the Bank's relationship with OLAF is working effectively.

3.4. European Court of Auditors

The *Audit Committee* continued its relations with the Court of Auditors as in previous years and under the tripartite agreement (between the Bank, Commission and Court of Auditors) signed in October 2003. The *Audit Committee* did not undertake any joint on-the-spot audits with the Court in 2004 and also noted that the 2004 audits on Bank-related matters had yet to be finalised by the Court.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2004 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE

The *Audit Committee* examined the Bank's consolidated and non-consolidated financial statements, including those of the Investment Facility for 2004 by reviewing the reports drawn up by Ernst & Young and by requesting further details on certain items in the financial statements, where necessary.

In 2004, the non-consolidated accounts continue to have been prepared in accordance with the general principles of the European Directive applicable while the consolidated financial statements have been prepared in accordance with the IFRS (International Financial Reporting Standards previously known as International Accounting Standards (IAS)) and the general principles of the European Directive applicable (the IFRS prevailing in the case of contrary provisions).

The *Audit Committee* noted the following matters:

- Subscribed capital and receivable reserves called but not paid stand at EUR 2103.6m, reflecting the total amounts to be paid (in eight equal instalments up to 31 March 2009) by the ten new member states and Spain following the capital increase at 1 May 2004.
- The Fund for General Banking Risks has been reduced by EUR 135 m compared to the 2003 year-end figure, as explained in Section 2.1.
- Specific provisions: Specific loan and guarantee provisions resulted in a EUR 82m charge to the 2004 Profit and Loss Account.
- Venture capital operations: Value adjustments amounting to EUR 76.2m have been recorded in the unconsolidated financial statements and EUR 81.6m in the consolidated financial statements. The Group did not apply the revised version of IAS 39 as published on 17 December 2003 since the EU has not endorsed the accounting standard for application in 2004. In particular, Venture Capital investments are individually valued at the lower of cost or attributable Net Asset Value (NAV) thus excluding any attributable unrealised gain that may be prevailing in the portfolio.
- Accounting treatment for the staff pension and health insurance scheme: An actuarial valuation (and change of valuation method for the Health Insurance Scheme) as at 30 September 2004 and rolled forward to the year-end, has resulted in an extraordinary charge in the Bank's profit and loss account of EUR 68.5m (following the EU Directive) for the combined Pension and Health Insurance Schemes. In the case of the Group financial statements (under IFRS rules whereby IAS 1 prohibits extraordinary items in the profit and loss account), actuarial variations are recognised as general administrative expenses. In strict application of IAS 19, the total actuarial deficit is EUR 240.8m, of which EUR 80m needs to be recognised in 2004. IAS 19 allows for the remaining EUR160.8m to be deferred for recognition in 2005 and beyond (according to the average remaining service life of the participants in each scheme). The Bank has adopted this possibility of deferred recognition.
- Impact of IFRS on the 2003 consolidated financial statements: Some reclassification of prior year figures has taken place as the interpretation of IFRS, and particularly as IAS 39 (Financial Instruments: Recognition and Measurement) and IAS 32 (Financial Instruments: Presentation and Disclosure) evolve. The overall consequences of the reclassification on the 31 December 2003 financial statements are: increase of EUR 470m in the Group's own funds; increase of EUR 586m in additional reserves and a net decrease by EUR 116m in the overall result.

The *Audit Committee* submits a separate report to the Board of Governor's regarding the financial statements of the Investment Facility, as annexed to this report[5].

In the light of the reviews it has carried out and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank[6]), the *Audit Committee* concludes that the Bank's consolidated and non-consolidated and the Investment Facility's financial statements (comprising the balance sheet, the statement of Special Section, the profit and loss account, the statement of own funds and appropriation of profit, the statement of subscriptions to the capital of the Bank, the cash-flow statement and the notes to the financial statements) have been drawn up correctly and that they give a true and fair view of the Bank's results and financial status according to the principles applicable to the Bank.

The *Audit Committee* is of the opinion that it has been able to carry out its work under normal conditions and that it has not been prevented from performing any task which it would consider relevant for its statutory mission. On this basis, the *Audit Committee* signed its annual statements on 3 March 2005*.*

[5] For the 2005 financial statements, a separate statement and report of the Audit Committee will be made in respect of the FEMIP Trust Fund.

[6] In respect of the 2004 financial statements (and for the first time), the representation letter from management provided assurance that official disclosures made on the financial statements are consistent with the results reported in the financial statements for the year ended 31 December 2004.

5. WORK PROGRAMME FOR 2005/2006

The operational activities of the Audit Committee in 2005/2006 will again depend on the developments envisaged in the Bank's operations and on the new challenges the Bank will face, as it engages in wider activities in new and possibly higher risk areas. In parallel with its usual activities and the specific actions identified above, the *Audit Committee* recognises a particular need to:

- keep up to date on new activities or products, including analyses of related risks and risk mitigation controls;
- monitor and consider developments pertaining to 'best banking practice' in the context of the Bank, and to provide external viewpoints on risk management and relevant corporate governance issues; and
- monitor international developments in corporate governance best practices which may impact on the scope of the role, and on the work, of the Audit Committee.

6. CONCLUSION

Overall, the *Audit Committee* is of the opinion that the Bank is conducting its affairs in accordance with the Statute and Rules of Procedures. The *Committee* recognises the significant measures taken by the Management Committee and the staff of the Bank to maintain, formalise and where necessary improve corporate governance, transparency, risk and control awareness and responsiveness.

The Audit Committee can also assure Governors that overall it has met its own responsibilities during 2004 by adopting and implementing a process that supports its understanding and monitoring of[7]:

- its own role in relation to the specific roles of others involved in the financial reporting process;
- critical financial reporting risks;
- effectiveness of financial reporting controls
- independence, accountability and effectiveness of the external auditor; and
- transparency of financial reporting.

The *Committee* believes that it has appropriate standing within the Bank, that appropriate relations with management and Bank staff exist and operate well, and that there are no detractions from the *Committee's* statutory mission and need to be independent.

Date , 10 May 2005

M. COLAS, Chairman **M. HARALABIDIS, Member** **R. POVEDA ANADÓN, Member**

Having participated in the work of the Audit Committee as Observers, we concur with the above report.

S.ZVIDRINA **M. DALLOCCHIO**

[7] The *Audit Committee* has again formally reviewed its own performance during 2004.

European Investment Bank

AUDIT COMMITTEE

ANNUAL REPORT TO THE BOARD OF GOVERNORS

INVESTMENT FACILITY

For the 2004 financial year

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INVESTMENT FACILITY

For the 2004 financial year

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1. INTRODUCTION

Establishment of the Investment Facility

Within the framework of the Cotonou Agreement, the Bank manages Members States' resources under the Investment Facility, (which are presented in a separate set of financial statements), in addition to associated own-resources lending in the Africa Caribbean and Pacific (ACP) and Overseas Countries and Territories (OCT). The Investment Facility was established within the Bank as an autonomous business unit and operations officially started on 1 April 2003.

Role of the Audit Committee

The statutory role of the EIB's Audit Committee is to verify that the Bank's operations have been conducted and its books kept in a proper manner.

The Audit Committee's core duties are to oversee the work performed by the external auditors and to ensure co-ordination of such work with that of the internal auditors to safeguard the independence and integrity of the audit functions, to follow-up on audit recommendations and to understand and monitor how Management is assessing the adequacy and effectiveness of internal control systems, risk management and internal administration. The financial regulation of the Cotonou Agreement provides for the audit and discharge procedures of the Investment Facility to be the same as those defined for the Bank within the Statute. As a result, the *Audit Committee* acknowledges its responsibilities for signing a statement to the Board of Governors in respect of the financial statements of the Investment Facility.

The annual report from the Audit Committee to the Board of Governors provides a summary of the Committee's activities during the past year. It covers the financial year 2004 as far as the Audit Committee's opinion on the Investment Facility's financial statements is concerned. For other aspects, it covers the period since the last Board of Governors' meeting.

2. DEVELOPMENTS WITHIN THE INVESTMENT FACILITY

2.1. Developments in the Investment Facility's activities

The Audit Committee noted a number of recent developments that could impact on its work in some respect. The key findings are reported below:

Operations: The procedures related to the loan and equity activities are similar to those previously audited for activities under the preceding Lomé agreement. The financial accounting and control aspects of the Investment Facility are very similar to the procedures for other such activities within the Bank, although separate accounts are used to reflect the revolving nature of the Facility. The systems supporting the procedures and controls are also common to the Bank and the Investment Facility. The Management Agreement is being defined by the Bank before being discussed with the Commission.

In terms of the volume and nature of Investment Facility activities in 2004, the actual signatures in 2004 were in relation to 16 projects, and 44 disbursements occurred relating to 15 projects. With the exception of one new global loan, the 2004 activities of the Investment Facility (loans and equity participation) continued to be of a similar nature as those in 2003 and they used identical systems, procedures and controls, all of which remained unchanged since 2003. One guarantee was signed in 2004 and the interest and commission yield was from four projects. There were no complex investment products used for undisbursed amounts, a position which is expected to remain during 2005.

Cotonou Agreement: The first five-year financial protocol of the Cotonou Agreement, which was signed in 2000, will formally expire at the end of February 2005. However, since it only entered into force on 1 April 2003, after completion of the ratification process, transitional measures will be introduced to extend its application to at least 2008[1]. The agreement of the second Financial Protocol under Cotonou, expected to run from 2008 to 2012 will in due course entail a decision on the amount of resources to be managed by the Bank in the ACPs. These concern the replenishment of the Investment Facility; the volume of Own Resources the Bank is ready to make available; and the subsidy endowment. The *Audit Committee* will pay attention to the emphasis provided in the text of the revised Cotonou Agreement to the risk-bearing nature of the Investment Facility.

EIB Own Resource Lending in ACP countries: Under the successive Lomé Conventions, as well as under the current Cotonou Agreement, the Bank has contributed own resources to the financial package provided to the ACP States. This contribution is of political significance, as the ACPs consider it an important signal of the Bank's continued commitment to supporting the EU's development co-operation policies on their territories. In addition, the Bank has, according to the usual procedure, indicated the amount and conditions applicable to own resources it can make available to complement the Investment Facility. The *Audit Committee* notes the Board of Governors decision that the loans granted by the Bank shall be the subject of a satisfactory guarantee from the Member States for their aggregate amount, plus all related sums.

The *Audit Committee* notes that the Investment Facility Committee is in the process of discussing the degree of risk that the Member States are willing to bear under the guarantee that they grant to the Bank for lending from its Own Resources under the Cotonou Agreement: i.e. (i) their understanding and expectations for the use of risk sharing (whereby the Member States take the political risk, and the Bank the commercial risk without counterguarantee from the Member States); and (ii) the degree of risk they would accept to bear when Own Resource loans are utilised, without risk sharing, to support both public and private sector investments in ACP countries.

Future outlook of the Investment Facility: The *Audit Committee* has received a presentation of the results achieved so far in terms of building up the Investment Facility portfolio, and also of the changes that have occurred in the business and operating environment, together with the impact on forecast operations of these and other constraints faced by the Bank in the implementation of its mandate.

2.2. Significant measures taken by the Investment Facility

From the Audit Committee's perspective, significant measures have been taken by the Investment Facility to respond to the changing environment and to manage the risks arising from trends in its activities:

Policy and Procedures:
The principles of "best banking practice" are applied in the policies and procedures which have been developed since the Investment Facility was created and which, in particular, provide:

- a common language on credit risk matters for all actors concerned by the Investment Facility implementation –and which take into consideration the Facility's development objectives as well as its remit to operate in all ACP and OCT countries and therefore include a number of adjustments providing for the flexibility required by the generally difficult operating environment; and
- a process for making equity investments and the elements of the investment approach in evaluating, executing and managing equity investments, and the basis for defining a strategy for the Investment Facility for investing in equity that covers its activities in both direct and indirect investments.

The *Audit Committee* notes Management's commitment to refine and adjust the policies and procedures regularly, in line with maturing experience, as the Investment Facility portfolio grows, so as to ensure a proper balance between financial goals and development objectives.

Ring-fencing of Investment Facility Management Costs: In the ACPs and Overseas Countries and Territories (OCTs), the Bank finances operations on its Own Resources and implements two[2] mandates entrusted by the Member States and the Commission, for which it receives a remuneration

[1] It could theoretically last beyond 2008, should the ratification of the second protocol be delayed.

[2] Investment Facility and Lomé Risk Capital

accounting for some 90% of its revenue from operations in this region. Of these mandates, the Investment Facility is the most significant because of its revolving nature (debt service payments flow back into the Facility to be re-invested), size and visibility. Furthermore, its remuneration system, based on a cost-recovery principle, calls for clear and transparent management and cost accounting.

The administrative arrangements for activities in the ACP countries and OCTs have been revised in 2004 to improve transparency in the treatment of ACP activities, i.e. clear and separate budgeting, accounting, financial control, auditing and reporting, notably for the Investment Facility. The *Audit Committee* notes that the revisions involve the ring-fencing of the management costs for the Bank's activities in the ACPs and OCTs, which is to be implemented in the framework of the 2005 budgetary exercise.

2.3. Specific measures taken by the Audit Committee

The Audit Committee has also taken some specific measures related to its own roles and responsibilities. The key measures are summarised below:

<u>Rules of Procedure Changes</u>: In accordance with the Rules of Procedure which became effective on 1 May 2004, the number of Audit Committee observers has increased and in 2004/2005, the *Committee* successfully started integrating the new Committee representatives. The *Audit Committee* has welcomed the support of the Bank and the Investment Facility to ensure that all members and observers understand and can demonstrate a knowledge and interpretation of the Investment Facility's activities and of the Audit Committee's roles and responsibilities.

<u>External Audit Re-tender:</u> The *Audit Committee* has designated Ernst & Young, the Bank's incumbent auditors, to provide external audit services from 1 January 2005 to 31 December 2008 under a new contract. The decision of the *Audit Committee* was made based on the cumulative points awarded to each tenderer under the award criteria defined in the procurement procedure. The *Audit Committee* acknowledges that the Management Committee would have preferred a change of auditors because of possible external perceptions regarding independence of long-serving auditors and in line with international trends to make frequent rotation. However, the *Audit Committee* considers that the threat to auditor independence from the Bank/Investment Facility and from the Audit Committee has been appropriately protected.

<u>A revised Manual of the Audit Committee</u> was approved by the *Audit Committee* in early 2005[3] to clarify roles and objectives stated within the current Statute and Rules of Procedure. The *Audit Committee* considers that the Statute, Rules of Procedure and revised Manual are suitable to reflect the current policies, missions and working practices of the *Audit Committee* in terms of its responsibilities related to the Investment Facility.

3. REVIEW OF AUDIT WORK

The *Audit Committee* held seven meetings in the year 2004. During those meetings, the *Audit Committee* regularly reviewed the work of the external and internal auditors.

3.1. External auditors

The *Audit Committee* reviewed the scope of the external auditors' work and concurred with the particular emphasis placed by the auditors on IT systems, valuation of structured products and financial instruments and Risk Management functions for market risk monitoring, the development of the Investment Facility, foreign exchange hedging of loans margins and compliance with new International Financial reporting Standards (IFRS). The *Committee* examined the various reports produced by Ernst & Young and discussed any other matters of importance with the external auditors and relevant competent members of the Bank's services.

The *Audit Committee* also performed the checks it deemed necessary to ensure the independence of the External Auditors.

[3] The previous Manual of the Audit Committee was dated 17 October 1997.

3.2. Internal Audit

In February 2005, the Internal Audit and the Evaluation Departments were combined to form a single, autonomous department. The Inspector General, Head of Department is responsible for consultation, liaison and cooperation with the Audit Committee and external bodies in accordance with the Charter for Internal Audit and the Terms of Reference for Evaluations. The *Audit Committee* particularly supports the promotion of the position of Internal Audit within the Bank and hence, the Investment Facility.

A number of the Investment Facility's activities share common systems and controls with those of the Bank. Although no specific Internal Audit/Internal Control Framework (ICF) exercises were undertaken in 2004 in respect of the Investment Facility, the *Audit Committee* reviewed each of the Internal Audit reports produced for the Bank's systems and controls. Overall, the *Audit Committee* is satisfied with the Bank's actions in response to internal and external audit recommendations. The Audit Committee was also consulted on the drafting of the Internal Audit/ICF work programme for 2005-2006.

Internal Audit is responsibility for co-ordinating investigations into cases of alleged wrongdoing. Its work is designed to (i) inform management of any allegations of fraud within the Bank (including the Investment Facility) or within projects financed by the Bank (again, including the Investment Facility), (ii) provide information about the fraud to enable appropriate actions to be taken and (iii) to inform the European Anti-Fraud Office in order to review the possibility of prosecution. No cases of alleged wrongdoing on Investment Facility projects had been reported to the *Audit Committee* as at April 2005.

The Evaluations division carries out *ex post* evaluations of projects financed by the Bank, once they have been completed and coordinates the self-evaluation process in the Bank. Evaluation studies of projects financed by the Investment Facility will be planned as part of the Bank's overall Evaluation portfolio as projects are completed.

3.3. European Anti-Fraud Office (OLAF)

In July 2003, the Court of Justice of the European Communities gave a ruling which provided the Bank with a legal framework for continuing its full cooperation with the European Anti-Fraud Office (OLAF), the EU's specialised body in combating fraud and corruption.

In 2004, no involvement from OLAF was required since no cases of alleged wrongdoing on Investment Facility projects were reported.

3.4. European Court of Auditors

The *Audit Committee* continued its relations with the Court of Auditors as in previous years and under the tripartite agreement (the latest one having been signed between the Bank, Commission and Court of Auditors in October 2003), which is referred to in Article 112 of the financial regulation for the 9th European Development Fund. The *Audit Committee* noted that the Court did not carry out any Investment Facility related audits in 2004.

4. THE FINANCIAL STATEMENTS AS AT 31 DECEMBER 2004 AND THE ANNUAL STATEMENTS OF THE AUDIT COMMITTEE

The Audit Committee examined the Investment Facility's financial statements for 2004 by reviewing the reports drawn up by Ernst & Young and by requesting further details on the financial statements, where necessary. The accounts have been prepared in accordance with the general principles of the European Directive applicable.

The Audit Committee noted the following matters:

- The Member States cover in full the expenses incurred by the Bank for the management of the Investment Facility for the first five years of the 9th European Development Fund[4]. Accordingly, the financial statements exclude such expenses.
- Interest on bank deposits arising from the funds provided by the Member States which have been received by the Bank on behalf of the Facility and which have not been disbursed yet is payable directly to the European Commission (in accordance with the Financial Regulation applicable to the 9th European Development Fund). Reflows, being repayment of principal or interest or commissions (other than appraisal fees) stemming from financial operations, and interest earned on reflows, are accounted for within the Facility.
- Venture capital operations: The Investment Facility did not apply the revised version of IAS 39 as published on 17 December 2003 since the EU has not endorsed the accounting standard for application in 2004. Based on reports from fund managers up to the balance sheet date, Venture Capital investments are valued on a line-by-line basis at the lower of cost or attributable Net Asset Value (NAV) thus excluding any attributable unrealised gain that may be prevailing in the portfolio.
- Foreign Exchange variations: some investments in venture capital operations and loans were disbursed and were denominated in currencies other than the Euro; an exchange loss –mainly unrealised- of EUR 1.1m resulted from the depreciation of those currencies against the Euro between the time of disbursement and the year-end.

In the light of the reviews it has carried out and the information it has received (including a favourable opinion from Ernst & Young on the financial statements and a representation letter from the Management of the Bank, (on behalf of the Investment Facility)), the *Audit Committee* concludes that the Investment Facility's financial statements (comprising the balance sheet, the profit and loss account and the notes to the financial statements) have been drawn up correctly and that they give a true and fair view of the Investment Facility's results and financial status according to the principles applicable to the Bank and to the Investment Facility.

The *Audit Committee* is of the opinion that it has been able to carry out its work under normal conditions and that it has not been prevented from performing any task which it would consider relevant for its statutory mission. On this basis, the *Audit Committee* signed its annual statement.

5. CONCLUSION

Overall, the *Audit Committee* is of the opinion that the Investment Facility is conducting its affairs in accordance with the Statute and Rules of Procedures of the Bank and within the framework of the Cotonou Agreement. The *Committee* recognises the significant measures taken by the Management Committee and the staff of the Bank and the Investment Facility to maintain, formalise and where necessary improve corporate governance, transparency, risk and control awareness and responsiveness.

The *Audit Committee* considers that overall, it has met its own responsibilities during 2004 by adopting and implementing a process that supports its understanding and monitoring of[5]:

- its own role in relation to the specific roles of others involved in the financial reporting process;
- critical financial reporting risks;
- effectiveness of financial reporting controls
- independence, accountability and effectiveness of the external auditor; and
- transparency of financial reporting.

[4] Council of the European Communities Decision of 8 April 2003.

[5] The *Audit Committee* has again formally reviewed its own performance during 2004.

The *Committee* believes that it has appropriate standing within the Bank and Investment Facility, that appropriate relations with management and Bank staff exist and operate well, and that there are no detractions from the *Committee's* statutory mission and need to be independent.

Date , 10 May 2005

M. COLAS, Chairman **M. HARALABIDIS, Member** **R.POVEDA ANADÓN, Member**

Having participated in the work of the Audit Committee as Observers, we concur with the above report.

S.ZVIDRINA **M. DALLOCCHIO**

Response of the Management Committee

To the Annual Reports of the Audit Committee

For the Year 2004

RESPONSE OF THE MANAGEMENT COMMITTEE TO THE ANNUAL REPORTS OF THE AUDIT COMMITTEE FOR THE YEAR 2004

1. Introduction

The Management Committee welcomes the Annual Reports of the Audit Committee.

This report
- sets out the approach of the Management Committee to audit and control issues and
- responds to certain comments and suggestions in the Audit Committee Report.

2. The approach of the Management Committee to audit and control issues

The Management Committee cooperates in a constructive way with the Audit Committee and the external auditors. It also collaborates with the European Court of Auditors whenever this European Institution proceeds with an audit of operations or funds, which engage EU budgetary resources and which are implemented or managed by the Bank.

The Management Committee ensures that Internal Audit reviews major business and establishes independent reports on its findings. Internal Audit also follows up on the implementation of agreed actions.

Through the above, the Management Committee demonstrates its commitment to a strong and effective audit and control structure for the EIB.

3. Developments within the Bank in 2004

3.1 Corporate Governance, Accountability and Transparency

Corporate governance at the Bank has been reinforced by a number of measures endorsed by the Board of Governors, decided by the Board of Directors and put into practice by the Management Committee. The Bank's policies and the measures taken are published on the web site in a Corporate Governance Statement (last updated in January 2005). The publication of the curricula vitae of Board and Audit Committee Members and the disclosure of financial interests of the Members of the Management Committee are specific examples of the efforts made in 2004.

Transparency/accountability constitutes one of the two pillars of the Bank's strategy, the other being value-added. As a publicly owned bank with the mission of furthering and supporting EU advancement, the Bank is committed to attaining a high level of transparency of its activities, thereby showing the value of its operational performance. A text describing the Bank's transparency policy is also accessible on the web site. In a recent report[1], the European Parliament appreciated the efforts made by the Bank in respect of transparency of its activities and policies.

The Bank's management has a constructive dialogue with the European Parliament, which publicly demonstrates the management's support of EU policies in the Bank's lending activities. This reinforces the Bank's role as a policy-driven bank.

The Bank has stepped up its efforts of explaining its contribution to EU policies to the public and is now providing a vast array of information through publications, particularly on its web site. In December 2004, the Bank announced a public consultation on information policy.

The Bank can only operate efficiently as a credit institution if banking relationships are managed appropriately. In recognising this, the Management Committee is committed to continuing to pay particular attention to transparency, but at the same time considers that it has to strike a balance between attaining full disclosure to interested third parties and the clear duty of the Bank to protect the legitimate business interests and confidentiality requirements of its clients, particularly those from the private sector.

[1] European Parliament report on the Activity Report 2003 of the European Investment Bank (2004/2187 (INI) –Final AG-0032/2005

3.2 Rules for Handling Possible Conflict of interest of Members of the Board of Directors and the Audit Committee

The members of the Board of Directors and of the Audit Committee are not employed by the Bank, but are appointed by the shareholders of the Bank on grounds of professional competence or experience and personal integrity. The publication of curricula vitae contributes to raising awareness of possible conflicts of interest for the members of the Board of Directors and of the Audit Committee.

Each member of these organs of the Bank signs a Code of Conduct. The code for members of the Board of Directors' obliges members to state any potential conflicts of interest. The President asks at each Board of Directors' meeting to declare any potential conflict of interests of the Board Members. They also have the moral obligation to abstain from taking a decision. Such declarations and abstentions from voting are recorded in the minutes of meetings and are published. A similar procedure is in place for members of the Audit Committee.

The Management Committee is confident that the shareholders exercise due diligence in the selection process of the members of the Bank's organs and that the incumbents manage conflict of interest situations in an appropriate manner. It is important that the Bank can draw upon expertise from the private and financial sectors in the Board of Directors and the Audit Committee. The current rules for disclosure of information enable the Bank to draw on this essential source of expertise in an entirely proper way.

3.3 Compliance

The Management Committee has decided on the organisational and on the budgetary arrangements to establish a centralised compliance function at the Bank, thereby further reinforcing its corporate governance. The recruitment of the Head of the Compliance Office is ongoing.

The European Ombudsman deals routinely with cases of complaints from civil society of the EU Member states. For cases outside the responsibilities of the European Ombudsman, an independent complaints mechanism will be set up by the Bank to handle these cases in a diligent and transparent manner.

3.4 Foreign exchange losses

The Management Committee recognised the unexpected negative outturns in respect of a small number of foreign exchange exposures of limited amount that were not reported correctly or consequently were not hedged in a timely fashion. Following the incidents, the responsible Directorates proceeded with making improvements to reporting controls and redefined their responsibilities.

3.5 Reinforcement of risk management policies and procedures

Building on the efforts made in previous years, the Management Committee continued to pay particular attention to risk management and control. In particular, the main risk management functions are now concentrated within the Bank in one independent directorate. Credit risk policies were updated and a new set of market and ALM risk policy guidelines were introduced. At the same time, a comprehensive reporting on credit, ALM, market and operational risks has increased the effectiveness and the quality of reporting and contributed to enhancing the information base of the Management Committee, the Board of Directors, and the Audit Committee, thereby improving the basis for decision-making and control.

3.6 Projects and Operations Monitoring

The post-signature monitoring of projects, promoters, borrowers and guarantors has been the subject of intense examination by the Bank services and Internal Audit. The Management Committee has addressed weaknesses by reinforcing the responsibility for physical project monitoring of the Project Directorate and by concentrating credit and financial monitoring of EU operations in the Risk Management Directorate. These arrangements commenced in January 2005 and staff resources for the reinforced monitoring in the Bank have been identified. Improvements should be expected and be demonstrable once these arrangements are fully operational. Monitoring will be an area of critical concern for management in 2005 and 2006.

3.7 External audit re-tender

The Audit Committee's authority in the selection of the external auditor is respected by the Management Committee. The Management Committee would have preferred a change in the external audit company to demonstrate unequivocally external audit independence. However, the Management Committee recognises that key partners have been rotated. It notes that regulation and best practice guidance in respect of the appointment of auditors is the subject of international debate and the Management Committee will pay particular attention to such developments and make detailed proposals for possible changes in the Rules of Procedure.

4. Developments within the Investment Facility in 2004

4.1 Policies and Procedures

The Management Committee is committed to refining and adjusting policies and procedures relating to the evaluation of all types of risk related to investments made in the context of the Cotonou Investment Facility (credit and equity risk as well as market and operational risk) so as to balance financial and development objectives. Such adjustments will take into account experience gained with investments made so far as well as new investment possibilities.

5. Priorities for 2005

5.1 Application of International Financial Reporting Standards (IFRS)

The Bank takes a keen interest in IFRS issues and is represented by a senior member of the Financial Control department among the 30 entities consulted worldwide by the International Accounting Standard Board for the revision of the International Accounting Standard (IAS) 39. The Management Committee will closely observe advances in EU policies with respect to adopting the revised version of IAS 39 as such developments will have an impact on valuation of the venture capital investments in the context of the Risk Capital Mandate given to the EIF and thus on the accounts of the EIF, the Bank and on the consolidated accounts of the EIB Group. The Bank will continue to establish and to publish the statutory financial accounts for the Bank as well as the consolidated accounts for the Group.

5.2 Coherent Corporate Operational Plan: "The COP for the EIB Group"

The reinforced focus on the notion of EIB Group forms part of the strategic considerations being proposed to the Board of Governors in June 2005*.* This strategic move takes better account of the Bank's majority shareholding in the EIF, almost 60% at the end of 2004, and the resulting obligation to present consolidated accounts. Taking into account the Governors' orientations, the Management Committee intends to present a consistent and coherent COP for the period 2006-2008 for the EIB Group, integrating the main pillars of operational strategy for the Investment Facility and the EIF.

5.3 Risk Management and Internal Controls

The Bank has considerably strengthened its risk management policies and procedures over recent years. This is an ongoing process and the Management Committee will continue to reinforce the overall control structures in the Bank. To that effect, the Inspectorate General was created in 2005, combining the Operations Evaluation Directorate and Internal Audit.

5.4 Follow up on Operation Monitoring

The Management Committee will pay attention to the evolution of credit and financial monitoring so as to improve the overall monitoring quality of all its operations and in order to gain demonstrable assurance regarding the soundness of the Bank's investments, including also all mandate operations.