

Board of Auditors’ Annual Report to the Board of Governors

Board of Auditors

European Stability Mechanism

1. Introduction

The Board of Auditors of the European Stability Mechanism (the "ESM") is established pursuant to Article 30 of the Treaty establishing the ESM (the "Treaty") and Article 24 of the ESM By-Laws ("By-Laws"). The members of the Board of Auditors are appointed by the Board of Governors, on the basis of Article 30 (1) of the Treaty and Article 24 (1) of the By-Laws.

The Board of Auditors is an independent body that inspects the ESM accounts and verifies that the operational accounts and the balance sheet are in order. Furthermore, it monitors and reviews the ESM's internal and external audit processes and

their results. In addition, it carries out independent audits in relation to the regularity, compliance, performance, and risk management of the ESM.

This report is addressed to the Board of Governors in accordance with Article 30 (4) of the Treaty and Article 24 (6) of the By-Laws and provides details on the audit work of the Board of Auditors, its work in relation to the financial statements of the ESM and its conclusions. This report will be made available also to the national parliaments and supreme audit institutions of the ESM Members, the European Court of Auditors, and the European Parliament.

2. Activities of the Board of Auditors

2.1. Meetings of the Board of Auditors

The Board of Auditors held eight meetings in 2021. Due to the ongoing Covid-19 pandemic, six of these meetings took place virtually. From 1 January 2022 to the date of the issuance of this report, the Board of Auditors continued its work and has held a further five meetings.

During its meetings, the Board of Auditors held regular discussions with the ESM management in relation to institutional developments and arising issues. Furthermore, the Board of Auditors was provided with regular updates on the activities of the ESM and the ESM governing bodies by the ESM Secretary General, received presentations by the ESM management and senior staff on specific topics requested by the Board of Auditors, and met regularly with the internal and external auditors. It

also held its own discussions in connection with the Board of Auditors' core mandate to:

- review the integrity and adequacy of the financial statements and the related control frameworks;
- perform selective efficiency and effectiveness audits in relation to the regularity, compliance, performance, and risk management of the ESM in accordance with international auditing standards, and;
- monitor and review the ESM's internal and external audit processes and their results.

In addition, the Board of Auditors met with the Board of Directors on 3 June 2021. Subsequently, the Chairperson of the Board of Auditors attended the annual meeting of the Board of Governors and met with the Chairperson of the Board of Governors to give briefings on the work and conclusions of the Board of Auditors.

In preparation of the Board of Auditors' report in respect of the ESM 2021 financial statements the Board of Auditors exchanged views with the Chairperson of the Board Risk Committee on 11 March 2022.

Furthermore, the Board of Auditors met with the Board of Directors, and the Board of Governors as well as the Chairperson of the Board of Governors, during the course of June 2022 to discuss the conclusions of this report.

2.2. Main activities

In line with its mandate, the Board of Auditors performed the following activities:

ESM financial statements

The Board of Auditors reviewed the ESM financial statements for the period ended 31 December 2021 as drawn-up by the Board of Directors on 28 March 2022.

The ESM financial statements were prepared and presented in accordance with the Directive 86/635/EEC of the Council of the European Communities of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions, as amended by Directive 2001/65/EC of 27 September 2001, by Directive 2003/51/EC of 18 June 2003 and by Directive 2006/46/EC of 14 June 2006.

The Board of Auditors discussed the process of the preparation of the ESM 2021 financial statements, as well as its observations in relation to accounting treatments, methodologies, and disclosures. In addition, the Board of Auditors exchanged views on these matters with the Chairperson of the Board Risk Committee on 11 March 2022. Furthermore, the Board of Auditors took note of the references and disclosures contained in the financial statements in relation to the Covid-19 pandemic and of the events taking place after the reporting period, such as the Russian invasion of Ukraine. The Board of Auditors discussed with the ESM management the content of such disclosures.

Subsequently, the Board of Auditors issued its report in respect of the ESM 2021 financial statements, which is included in the *ESM 2021 Annual Report*. Based on the work undertaken and the information obtained, including the unqualified audit opinion of the external auditors, the Board of Auditors concluded that to the best of its judgement, no material matters have come to its attention that would prevent it from recommending that the Board of Governors approve the ESM financial statements for the year ended 31 December 2021 as part of the *ESM 2021 Annual Report*.

External auditor

The Board of Auditors monitored and reviewed the external audit processes performed by Ernst & Young Société anonyme ("Ernst & Young") in line with Article 24 (4) of the ESM By-Laws. This included a review of the annual audit plan setting out the audit methodology and approach, as well as the monitoring of its implementation through regular meetings and discussions with the external auditors. The Board of Auditors also performed a review of the external audit working papers. The review was conducted at the Ernst & Young premises over two full days, on 1 and 2 March 2022. In this context, the Board of Auditors discussed with Ernst & Young the audit procedures applied for the most material lines of the balance sheet and profit and loss accounts. The Board of Auditors reviewed and challenged the evidence provided, the controls in place, as well as the results of the applied audit procedures within the context of the Covid-19 pandemic. Furthermore, the Board of Auditors reviewed the report addressed to the Board of Auditors issued by the external auditor in compliance with EU Regulation 537/2014 of the European Parliament and of the Council of 16 April 2014 describing the audit process, scope, and its results. The Board of Auditors took also note that the term of Ernst & Young as ESM external auditor will come to an end in June 2023. In this context, the Board of Auditors would like to highlight the importance of the regular dialogue with the external auditors, as well as the continued access to the external audit working papers.

Internal audit

The Board of Auditors met regularly with the internal audit function in closed sessions to monitor internal audit processes and their results. The internal audit function is an independent assurance function designed to add value and improve the operations of the ESM. It assists the ESM in fulfilling its mandate by bringing a systematic and disciplined approach to evaluating and improving the effectiveness and procedural efficiency of the ESM's risk management, control, and governance processes. As part of its responsibilities, it also evaluates the adequacy, effectiveness, and timeliness of actions taken by management on findings and recommendations issued by the internal audit function, the external auditor, and the Board of Auditors.

The internal audit function reports directly to the ESM Managing Director and is under the oversight of the Board of Auditors. The Board of Auditors examined and discussed the reports issued by the internal auditor, as well as the status of implementation of the related agreed actions by the ESM. In addition, the Board of Auditors also discussed the internal audit plan for 2022, following its approval by the ESM Managing Director. Furthermore, the Board of Auditors was informed about the results of the internal audit quality assessment that was conducted in 2021 by an independent assessor. The assessment concluded that the ESM internal audit processes complied with the required internal audit standards (International Professional Practices Framework of the Institute of Internal Auditors).

Covid-19 impact

The Board of Auditors took note of the challenges and uncertainties posed by the ongoing Covid-19 pandemic that persisted in 2021 and the steps taken by the ESM to mitigate and respond to them. The Board of Auditors held several meetings with the ESM Managing Director, the Secretary General,

and senior staff to obtain updates on the evolving situation and its implications for the institution and its future.

The focus of these exchanges was both the operational response of the institution, as well as the increasingly challenging economic environment and its impact on the ESM 2021 financial statements.

The Board of Auditors noted that the ESM management continued undertaking preventive measures and working arrangements to safeguard staff and ensure business continuity.

The Board of Auditors is appreciative of the information provided so far and will continue to monitor developments in this regard.

Exchanges with the ESM management

The Board of Auditors met with the ESM Managing Director, members of the Management Board, and senior staff to discuss and review relevant issues and developments. Particular focus was placed on the areas of risk inherent to the operations of the ESM. Furthermore, the Board of Auditors received, at its request, various written representations from the ESM management concerning issues of oversight. During the course of the past year, this included presentations in relation to operational and balance sheet resilience in light of risks and challenges posed by the continuing Covid-19 pandemic, derivative operations, efforts around ESM capital preservation, and the debt sustainability analysis methodology.

Furthermore, the Board of Auditors received updates in relation to the construction of the new ESM building. The Board of Auditors was kept informed on the progress of the internal audit that was performed in 2021 in relation to the governance of the building project and had exchanges with the external service provider supporting the audit.

The Board of Auditors has also shared some observations with the ESM Managing Director in a letter, which included, among other things, recommendations in relation to the reviewing of the ESM accounting manual and policies taking into account the ESM needs and best practices and consideration of recent developments in sustainability reporting.

Lastly, the Board of Auditors was also regularly informed of the progress of the ESM reform and the update of policies related to its work. The Board of Auditors was updated on the ongoing revisions of the ESM Treaty, By-Laws, and other legal documents performed in this context and was consulted on the update of audit-related provisions within the ESM Code of Conduct that was revised in February 2021. The Board of Auditors also reviewed and updated its own Code of Conduct, as well as its Rules of Procedure.

2.3. Audit conducted by the Board of Auditors

In addition to the annual statutory audit by the independent external auditor and the audits performed by the internal audit function, the Board of Auditors carried out audit procedures in accordance with Article 30 (3) of the Treaty and Article 24 (4) of the By-Laws.

While the ESM recruitment system had been up to now commensurate to the size and nature of the ESM, as a crisis resolution mechanism, the Board of Auditors considered that, in view of its reached maturity and upcoming enhanced mandate, the institution should review its recruitment practices.

In light of the above, the Board of Auditors launched an audit on the ESM recruitment procedures in 2021, with the assistance of subject matter experts from the European Court of Auditors. The audit was concluded in the course of 2022. The main objective of the audit was to assess whether the ESM's recruitment framework was appropriate in terms of rigour and robustness.

The audit found that the ESM had in place a recruitment system able to attract talented staff within a short time period. At the same time, the audit also identified several areas for improvement with a view to the further formalisation and application of the ESM recruitment framework. As such, the audit recommended specific improvements in relation to, for example, the human resources' strategy, the applicable recruitment rules and procedures, including the potential reconsideration of the citizenship eligibility criteria, the information made available to external candidates, and the mechanisms of appeal available to them.

The recommendations arising from these findings were accepted by the ESM management. The Board of Auditors noted that ESM management confirmed its commitment to address the issued recommendations.

3. In Closing

The Board of Auditors considers that, during the year, it adopted a balanced work plan in terms of focus, objectives, and means utilised to obtain the necessary assurance required for the discharge of its mandate. The Board of Auditors also confirms that it received the expected full support from ESM management.

The Board of Auditors will continue to monitor the implementation of its audit recommendations and those of the internal audit division.

Luxembourg, 16 June 2022

Appendix - composition of the Board of Auditors

According to Article 30 (1) of the Treaty, the Board of Auditors is to have five members, appointed by the Board of Governors for a non-renewable term of three years. In line with Article 30 (1) of the Treaty and Article 24 (1) of the By-Laws two members are appointed upon proposal of the Chairperson of the Board of Governors, two members upon nomination by the supreme audit institutions of the ESM Members based on a rotation system and one upon nomination by the European Court of Auditors. The members of the Board of Auditors are as follows:

- Mr Baudilio Tomé Muguruza, nominated by the European Court of Auditors (from 17 December 2019). Mr Tomé Muguruza has been serving as Chairperson of the Board of Auditors since 22 January 2020.
- Mr Tommaso Fabi, appointed upon proposal of the Chairperson of the Board of Governors (from 1 April 2019). Mr Fabi has been serving as Vice-Chairperson of the Board of Auditors since 20 October 2021 and has been replaced by Ms Lucia Kašiarová as of 25 April 2022.
- Mr Ilias Dimitriadis, appointed upon nomination by the Supreme Audit Institution of Greece (from 8 October 2019). Mr Dimitriadis has been serving as Vice-Chairperson of the Board of Auditors since 27 April 2022.
- Mr Akis Kikas, appointed upon nomination by the Supreme Audit Institution of Cyprus (from 8 October 2021).
- Mr Jochen Wenz, appointed upon proposal of the Chairperson of the Board of Governors (from 8 October 2021).
- Ms Lucia Kašiarová, appointed upon proposal of the Chairperson of the Board of Governors (from 25 April 2022).

The Board of Auditors notes that the non-renewable three-year terms of Mr Ilias Dimitriadis and Mr Baudilio Tomé Muguruza will end on 7 October 2022 and 16 December 2022 respectively. In line with the ESM Treaty and the ESM By-Laws, the Board of Governors will therefore need to appoint two new members to the Board of Auditors within these timelines.

