

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 as well as 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 14 meetings in 2020. Due to the ongoing Covid-19 pandemic, 12 of these meetings took place virtually. From 1 January 2021 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 oversight 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 Chairperson of the Board of Auditors met with the Board of Directors on 4 June 2020. 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 2020 Financial Statements, the Board of Auditors exchanged views with the Chairperson of the Board Risk Committee on 10 March 2021. Furthermore, the Chairperson of the Board of Auditors met with the Board of Directors and the Board of Governors during the course of June 2021 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 2020 as drawn-up by the Board of Directors on 30 March 2021.

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 2020 Financial Statements, as well as its observations in relation to accounting treatments, methodologies, and disclosures. In addition, the Board of Auditors exchanged views on relevant matters with the Chairperson of the Board Risk Committee on 10 March 2021. Subsequently, the Board of Auditors issued its report in respect of the ESM 2020 Financial Statements, which is included in the *ESM 2020 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 2020 as part of the *ESM 2020 Annual Report*.

The Board of Auditors takes particular note of the extraordinary income recorded in the amount of €235.7 million. This amount is linked to the compensation by several ESM Members of the negative interest charged on the cash balances held with their respective national central banks to limit the negative implications on the ESM's paid-in capital. As such, the ESM received €131.7 million from Germany on 11 February 2020, €6.0 million from Italy on 3 July 2020, and €98.0 million from France on 18 November 2020. In addition, the Board of Auditors also took note of the references and disclosures contained in the financial statements in relation to the Covid-19 pandemic. The Board of Auditors discussed with the ESM Management the content of related disclosures.

External auditors

The Board of Auditors monitored and reviewed the external audit processes performed by Ernst & Young Société anonyme ("Ernst & Young"). 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. In light of the Covid-19 pandemic, the review was conducted remotely over two full days on 2 and 3 March 2021. In this context, the BoA 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 statutory external audit was conducted in accordance with the requirements of EU Regulation 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding the statutory audit of public-interest entities, the Luxembourg Law of 23 July 2016 concerning the audit profession, and the International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier".

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 auditors, 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 actions agreed by the ESM. In addition, the Board of Auditors also discussed the internal audit plan for 2021, following its approval by the ESM Managing Director. Furthermore, the Board of Auditors reviewed and provided comments on the draft Internal Audit Charter prior to its approval by the ESM Board of Directors.

Covid-19 impact

The Board of Auditors took note of the challenges and uncertainties posed by the rapidly unfolding Covid-19 pandemic and the steps taken by the ESM to mitigate and respond to them. In light of the Covid-19 pandemic, 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 2020 Financial Statements.

The Board of Auditors noted that the ESM management took swift action putting in place preventive measures and working arrangements to safeguard staff and ensure business continuity. The Board of Auditors also monitored developments in relation to the comprehensive European economic policy response to the Covid-19 pandemic including the preparations around the ESM Pandemic Crisis Support instrument, which was made operational by the ESM Board of Governors on 15 May 2020.

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

Exchanges with 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, these included presentations in relation to operational and balance sheet resilience in light of risks and challenges posed by the Covid-19 pandemic, derivative operations, or the ESM mitigation efforts in response to the prolonged low interest rate environment.

The Board of Auditors was also regularly informed on the progress of the ESM reform. The Board of Auditors was updated on the ongoing revisions of the ESM Treaty and By-Laws performed in this context and was consulted on the update of audit-related provisions within the ESM By-Laws.

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 its own audit procedures in accordance with Article 30 (3) of the Treaty and Article 24 (4) of the By-Laws.

During 2020, the Board of Auditors with the assistance of subject matter experts from the Maltese National Audit Office performed an audit on the governance arrangements of the institution's internal committees. The objective of this audit was to establish whether such arrangements facilitate the fulfilment of the internal committees' objectives.

Three key audit areas were identified. The first area focused on structural considerations. In this respect, the audit team sought to review the set-up of the internal committees in terms of their organisation and how they fit together. In so doing, it intended to ascertain the adequacy of such structures in enabling the ESM to fulfil its functions. The second element was composition. Here, attention was drawn towards the analysis of the composition of each committee, addressing matters such as terms of appointment, skills and expertise, as well as independence. This was to facilitate the determination of whether the committees were appropriately composed to fulfil their mandates. The third and final area of interest related to functionality. This element assumed importance in the assessment of whether the system of governance of each committee was conducive to its function. Criteria applied included the regularity of meetings held, the retention of records, and mechanisms of performance assessment employed.

Overall, the audit found that:

- The structure of the internal committees enables the ESM to fulfil its functions, yet scope for improvement exists in relation to the setting up and periodic review of these committees.
- Although the composition of the internal committees facilitates the fulfilment of the ESM's mandate, some potential risks remain due to limited rotation within the committees.
- The systems of governance of each internal committee are conducive to their function, yet opportunities for improvement with regard to reporting and performance review were identified.

Recommendations arising from these findings were agreed with the ESM Management. The Board of Auditors notes that ESM Management confirmed its commitment to address the issued recommendations.

2.4. Ongoing audits by the Board of Auditors

The Board of Auditors has continued with its preparations of an audit on ESM recruitment procedures. In this context, the Board of Auditors developed terms to formalise the engagement modalities for subject matter experts supporting its audit work.

In addition, the Board of Auditors developed a procedure seeking to guide the process for the selection of subject matter experts as well as the performance of the underlying audit work.

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, 17 June 2021

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 Noel Camilleri, appointed upon nomination by the Supreme Audit Institution of Malta (from 8 October 2018).

- Mr Ilias Dimitriadis appointed upon nomination by the Supreme Audit Institution of Greece (from 8 October 2019).
- Ms Irena Petruškevičienė, appointed upon proposal of the Chairperson of the Board of Governors (from 8 October 2018). Ms Petruškevičienė has been serving as Vice-Chairperson of the Board of Auditors since 9 December 2019.
- Mr Tommaso Fabi, appointed upon proposal of the Chairperson of the Board of Governors (from 1 April 2019).

The Board of Auditors notes that the non-renewable three-year terms of Mr Noel Camilleri and Ms Irena Petruškevičienė will end on 7 October 2021. 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 by 8 October 2021.

