

European Stability Mechanism



ESM management comments on the Board of Auditors' Annual Report to the Board of Governors

for the period ended 31 December 2017

Dear Chairperson,

I would like to thank you for the Board of Auditors' Annual Report to the Board of Governors for the period ended on 31 December 2017.

The ESM management welcomes the conclusions of the report and views the report as recognition of the sustained efforts undertaken in establishing the ESM as a mature institution over the last five years. Since the establishment of the ESM in 2012, the ESM management has placed high importance

on its interactions with the Board of Auditors and on addressing its recommendations. The ESM management is pleased to see that these efforts were acknowledged by the Board of Auditors.

I would like to use this opportunity to provide you with an overview of the audit oversight and review activities the ESM was subject to throughout the year.

Overview of the dialogue with the Board of Auditors

During the past year, the ESM management met on a regular basis with the Board of Auditors. In 2017, the Board of Auditors held seven meetings at the ESM and met once with the Board Risk Committee. Additionally, the Chairperson of the Board of Auditors met with the Board of Directors on 9 June 2017. The Chairperson of the Board of Auditors also met with the Chairperson of the Board of Governors and attended the Annual Meeting of the Board of Governors. In 2018 to date, the Board of Auditors has held a further five meetings.

During these meetings, the Board of Auditors was regularly updated on the ESM activities, the decisions of the ESM governing bodies, and any other relevant issues and developments. Key members of ESM staff and the ESM management devoted considerable time and effort to discussing relevant topics, submitting presentations, and providing any cooperation and assistance needed for the successful discharge of the mandate of the Board of Auditors. The Board of Auditors also met regularly with the Internal Audit function in private sessions and monitored and reviewed the work and independence of the external auditor.

As part of its mandate, the Board of Auditors also reviewed the ESM Financial Statements as at 31 December 2017 (the "Financial Statements") as well as the working papers of the external auditor on the statutory audit of the Financial Statements. Subsequently, the Board of Auditors prepared a report in respect of the Financial Statements which will be included in the ESM 2017 Annual Report along with the Financial Statements and the external auditor's report in respect of these Financial Statements.

Audit procedures 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 several audits of the ESM in accordance with Article 30 (3) of the ESM Treaty. These audits were conducted with the assistance of subject matter experts designated in line with Article 24 (5) of the ESM By-Laws.

As such, an audit of the ESM procurement framework was completed in July 2017 with the assistance of subject matter experts from the European Court of Auditors. In April 2018, an audit on the ESM usage of external consultancy services was completed with the assistance of subject matter experts from the French Supreme Audit Institution. Lastly, an audit of the ESM internal control framework carried out with the assistance of subject matter experts from the European Court of Auditors is close to completion.

The ESM provided the necessary cooperation, access and support required for the completion of these audits which involved around 20 percent of the ESM staff.

Audit procedures conducted by the Internal Audit function

During the past year, the Internal Audit function performed nine audits and reported that the 2017 Audit Plan, which is approved by the ESM management and presented to the Board of Auditors, was achieved. The audits contained in the Audit Plan intended to prioritise the main risks faced by the institution while providing coverage of all areas of activity over time.

For each audit performed, the Internal Audit function also tested the design and operating effectiveness of the internal controls for the activities in scope. In addition, the Internal Audit function also performed its annual review of the ESM entity level controls.

As in prior years, the ESM management will continue its sustained efforts to ensure the timely closure of internal audit recommendations, particularly those relating to high risk matters.

The Internal Audit function had full unrestricted and private access to the Board of Auditors and confirmed that there were no impairments to the function's independence and objectivity throughout the year. In 2017, there were six meetings between the Internal Audit function and the Board of Auditors and four further meetings to date in 2018. The Internal Audit function reported to the Board of Auditors

on the results of the internal audits conducted; the progress in implementing the 2017 Audit Plan; and, on a quarterly basis, the implementation status of the recommendations issued by the Internal Audit function, the Board of Auditors and the independent external auditor.

Audit procedures conducted by the independent external auditor

Article 22 (2) of the ESM By-Laws requires mandatory rotation of the ESM external auditor every six years. On 15 June 2017, the Board of Governors appointed Ernst & Young Société anonyme, Luxembourg ("Ernst & Young") for a term of three years as the new independent external auditor of the ESM. Ernst & Young replaced PricewaterhouseCoopers Société coopérative.

During 2017, Ernst & Young carried out the annual statutory audit and issued an audit report confirming that, based on the audit, the Financial Statements give a true and fair view of the financial position of the ESM as of 31 December 2017 and of the results of its operations and its cash flows. This audit opinion is also consistent with the additional report issued by the external auditor to the Board of Auditors. Furthermore, Ernst & Young confirmed that no matters came to its attention that would require comment in the Management Letter.

The statutory audit was conducted in accordance with the requirements of the EU Regulation¹, 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. As part of the statutory annual audit, Ernst & Young also reviewed the principal internal control procedures in place to ensure the accuracy and reliability of the ESM accounting records and the safekeeping of assets.

¹ Regulation EU No 537/2014 of The European Parliament and of the Council of 16 April 2014 on specific requirements regarding statutory audit of public-interest entities.

In addition to the statutory audit of the Financial Statements, the ESM accounts were also subject to limited review procedures required for the issuance of comfort letters by the external auditors in connection with the issuance of US-dollar denominated bonds.

The Board of Auditors met with Ernst & Young representatives on five occasions in 2017, and on two further occasions to date in 2018. During these meetings, the Board of Auditors extensively discussed with Ernst & Young ongoing audit processes and their results. In addition, the external auditor also presented to the Board of Directors and the Board of Governors the external auditors' report in respect of the Financial Statements.

Ernst & Young confirmed both to the Board of Auditors and the ESM management compliance with the relevant ethical requirements regarding independence. In addition, Ernst & Young also confirmed that unlimited access to documents and staff had been granted and noted good cooperation by the ESM management.

ESM Internal Control Framework

The ESM recognises the importance of effective internal controls that provide reasonable assurance that the institution can deliver on its mandate, prevent losses, and prepare reliable Financial Statements free from material misstatements. In line with the commitment made to the Board of Directors, the ESM aligned with the principles of the Basel Committee's Framework for Internal Control Systems in Banking Organisations. The ESM internal control framework is embedded in the daily operations and comprises entity level, process level, and information technology controls, consistent with the nature, complexity and risks inherent in ESM activities.

Internal controls are subject to scrutiny by management and periodic independent review by the Internal Audit function, the Board of Auditors and the external auditor. In addition, the Board

of Directors, directly and through the Board Risk Committee, holds periodic discussions with the ESM management on the status of the ESM internal controls.

Assisted by the Management Board, the Managing Director sets a strong tone from the top, demonstrating commitment to integrity and ethical values, and overseeing internal controls across all areas of the ESM. Each year, the Managing Director issues a management report on the state of internal controls to the Board of Directors and the Board of Auditors. Any material or significant deficiencies identified during the management assessment are noted in the report together with management action plans to address them.

The ESM management remains committed to maintaining and strengthening the ESM internal control environment and seeks to address any items identified in the management action plan in a timely manner.

In closing

I would like to note that the ESM management is appreciative of the ongoing constructive feedback that the Board of Auditors has provided over the past years which helped to continuously improve the work of the ESM. We will continue to foster the mutually constructive, yet appropriately independent relationships among the ESM management, the Board of Auditors, as well as the internal and external auditors.

The ESM management remains confident that its policies, procedures and staff enable the institution to successfully deliver on its current and possible future mandate.

I look forward to continuing our good working relationship in the future.

Sincerely,

Klaus Regling
Managing Director