

BOARD OF AUDITORS' ANNUAL REPORT TO THE BOARD OF GOVERNORS

for the period ended 31 December 2016

Board of Auditors

European Stability Mechanism

1. INTRODUCTION

The Board of Auditors of the European Stability Mechanism (further referred to as the "ESM") is established pursuant to Article 30 of the Treaty establishing the ESM (the Treaty) and Article 24 of the ESM By-Laws.

The Board of Auditors carries out independent audits, inspects the ESM accounts, audits regularity, compliance, performance, risk management and monitors as well as reviews the ESM's internal and external audit processes and their results.

This report is addressed to the Board of Governors in accordance with Article 30 (4) of the Treaty and Article 24 (6) of the ESM By-Laws and provides

details on the audit work of the Board of Auditors, its audit findings in relation to the financial statements of the ESM and its conclusions and recommendations for the period from 1 January to 31 December 2016. 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.

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 ESM By-Laws. Changes in the composition of the Board of Auditors are detailed in the Appendix.

2. ACTIVITIES OF THE BOARD OF AUDITORS

2.1. Meetings of the Board of Auditors

The Board of Auditors met on eight occasions in 2016, during which it held regular discussions with the ESM Management in relation to organisational and management developments and oversight questions.

During their meetings the Board of Auditors was provided with regular updates on the activities of the ESM and the ESM governing bodies, received presentations by management on specific topics requested by the Board of Auditors and, of course, met on a number of occasions with the internal auditor and the external auditor. It also held its own

discussions in connection with the Board of Auditors' core mandate:

- reviewing the integrity and adequacy of the financial statements and the related control frameworks,
- performing selective efficiency and effectiveness audits on the regularity, compliance, performance and risk management of the ESM in accordance with international auditing standards, and
- monitoring and reviewing the ESM's internal and external audit processes and their results.

Additionally the Board of Auditors met with the Board of Directors on 10 June 2016. 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.

From 31 December 2016 to the date of this report, the Board of Auditors continued its work as set out above, and has held a further two meetings and instituted a new audit of the ESM Procurement Framework.

2.2. Scope

The Board of Auditors has:

- performed limited review procedures in accordance with Article 30 (3) of the ESM Treaty and Article 24 (4) of the ESM By-Laws focusing on the ESM investment operations (with the assistance of subject matter experts from the Irish supreme audit institution). This audit was finalised in February 2017. Further audit work is planned in 2017.
- reviewed whether, and how far, recommendations arising from the previous Annual Reports to the Board of Governors were considered and implemented.
- reviewed the ESM Financial Statements for the period ended 31 December 2016 as drawn-up by the Board of Directors on 30 March 2017. 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.
- noted that in accordance with the aforementioned financial statements, the balance sheet totals as at 31 December 2016 amount to EUR 793.1 billion and consist on the assets side mainly of loans and advances to euro area member states (EUR 72.7 billion), debt securities (EUR 30.5 billion), subscribed capital called but not paid (EUR 285 million) and subscribed capital ("authorized capital" according to Article 8 of the Treaty establishing the ESM) not yet called and unpaid (EUR 624.3 billion). The total own funds amount to EUR 707.0 billion. The total liabilities (EUR 86.1 billion) are composed mainly of debts evidenced by certificates (EUR 85.7 billion). The net profit for the financial year amounts to EUR 569 million, mainly the result of interest receivable and similar income (EUR 842 million), and net profit on financial operations (EUR 287 million), offset by interest payable and similar charges (EUR 533 million) and general administrative costs (EUR 53 million). A notable feature of the results is the impact of lower (even sometimes negative) short- and long-term interest rates or yields, which have an important impact on the economic out-turn, and which also necessitated some change in the presentation of the accounts.
- monitored and reviewed external audit processes performed by PricewaterhouseCoopers, Société coopérative. This included a review of their risk assessments, audit working papers and documentation with the assistance of a subject matter expert of the European Court of Auditors. Furthermore, the Board of Auditors reviewed the Special Topic Report which is issued by the external auditor each year, covering an additional area related to the financial reporting process in further depth.
- met with the ESM Managing Director and members of the Management Board including the Deputy Managing Director and Chief Finance Officer, the Secretary General and the Chief Corporate Officer as well as the Heads of Corporate Governance and Internal Policies, Finance and Control, Funding, Investment and Treasury, Risk Management and Compliance, Internal Audit and other ESM senior staff and discussed as well as reviewed relevant issues and developments.
- monitored and reviewed the internal audit processes and their results according to Article 24 (4) of the ESM By-Laws.
- received at its request various written representations from the ESM Management concerning issues of oversight interest.

3. IN CLOSING

The ESM, for the period under review, was in its fourth year of full operation.

The Board of Auditors considers that it had adopted a balanced work plan during the year 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 the ESM Management.

There are no findings or recommendations that the Board of Auditors would like to report to the Board of Governors for the year under review.

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. 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. At the end of 2016, the members of the Board of Auditors were as follows:

- Mr Jean Guill, upon proposal of the Chairperson of the Board of Governors (from 8 October 2015)
- Mr Andrew Harkness, nominated by the Comptroller and Auditor General of Ireland (from 8 October 2015)
- Mr Günter Borgel, upon proposal of the Chairperson of the Board of Governors (from 1 April 2016), replacing Ms Katarina Kaszasová, who resigned from the Board of Auditors as of 31 December 2015 due to changes in her professional engagements)

- Mr Francois-Roger Cazala, nominated by the Cour des Comptes of the French Republic (from 8 October 2016, replacing Mr Ulrich Graf whose term expired on 7 October 2016)
- Mr Kevin Cardiff, nominated by the European Court of Auditors (from 17 December 2016 replacing Mr Igors Ludboržs whose term expired on 16 December 2016)

Mr Igors Ludboržs and Mr Andrew Harkness were elected to be Chairperson and Vice-chairperson of the Board of Auditors, respectively, for a one year term as of 8 October 2015. In view of expected changes in the composition of the Board, these terms of office were extended by the Board of Auditors so that Mr Igors Ludboržs remained Chairperson until 16 December 2016, the date at which his term expired. Similarly, Mr Harkness remained Vice-chairperson until 21 February 2017, on which date Messrs. Cardiff and Cazala were elected Chairperson and Vice-chairperson, respectively.