

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 2022. From 1 January 2023 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 was informed about institutional developments and arising issues through regular discussions with the ESM Management, as part of its oversight role. Furthermore, the ESM Secretary General provided the Board of Auditors with regular updates on the ESM activities and the ESM governing bodies' decisions. The Board of Auditors also requested presentations by the ESM management and senior staff on specific topics and met regularly with the internal and external auditors to fulfil its mandate.

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 the context of its mandate, the Board of Auditors also exchanged views with the Chairperson of the Board Risk Committee on 10 March 2023. The Board of Auditors also presented its report in respect of the ESM 2022 financial statements, to the Board of Directors on 30 March 2023. Furthermore, the

Chairperson of the Board of Auditors met with the Board of Directors on 8 June 2023 and attended the annual meeting of the Board of Governors to discuss the conclusions of this report. Lastly, the Chairperson of the Board of Auditors had also a bilateral meeting with the Chairperson of the Board of Governors, during the course of June 2023.

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 2022 as drawn-up by the Board of Directors on 30 March 2023.

The Board of Auditors followed the process of the preparation of the ESM 2022 financial statements and provided the ESM with 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 10 March 2023 and on a regular basis with the external auditor. In particular, the Board of Auditors took note that 2022 was the first full financial year that ended with net loss for the ESM and discussed the reasons for it. Furthermore, the Board of Auditors discussed the content of disclosures contained in the financial statements in relation to the Russian invasion of Ukraine and reviewed the subsequent events, such as Croatia's accession to the ESM, the market volatility and its potential effects on the banking sector, in light of recent failures. Finally, the Board of Auditors requested information on the progress of the ESM building project and the impact of prevailing economic conditions, the rapidly increasing and volatile construction prices on the overall costs of the project, which could not be fully quantified at that point. At the same time, upon proposal by the Board of Auditors a relevant disclosure was included in the ESM 2022 financial statements.

Subsequently, the Board of Auditors issued its report in respect of the ESM 2022 financial statements, which is included in the *ESM 2022 Annual Report*. Based on the work undertaken and the information obtained, including the unqualified audit opinion of the external auditor, 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 2022 as part of the *ESM 2022 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 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 auditor. 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 2 and 3 March 2023. 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. Based on presentations and discussions, the Board of Auditors identified additional matters that merited further investigation. Furthermore, the Board of Auditors reviewed the report prepared and issued by the external auditor which is addressed to the Board of Auditors 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.

Ernst & Young's term ending in June 2023, the ESM held a public procurement for a new external auditor. Two Board of Auditors members observed the process, and KPMG was selected with no objections from the Board of Auditors. Consequently, the ESM Board of Governors appointed KPMG as the external auditor for 2023-2025, as per Article 29 of the Treaty and Article 22 (1) of the By-Laws.

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 audit function, as well as the status of implementation of the related agreed actions by the ESM. In addition, the Board of Auditors also endorsed the internal audit plan for 2023, following its approval by the ESM Managing Director.

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. A particular focus was placed

on the areas of risk inherent to the ESM operations. Furthermore, at its request, the Board of Auditors received various written presentations from the ESM Management concerning issues of oversight. During the course of the past year, this included presentations in relation to the ESM's policies framework, derivative operations, efforts around capital preservation, and early warning system methodology. In addition, the Board of Auditors organised a presentation by the Audit Office of the Republic of Cyprus on the Office's recent audit of Cypriot Public Debt Management. The ESM relevant functions also attended the presentation.

Last year, the Board of Auditors recommended the review of the ESM accounting manual and policies taking into account the ESM's needs and best practices. During the year, the Board of Auditors followed up on this recommendation and reiterated the need of its implementation without undue delay.

Furthermore, the Board of Auditors was kept informed on the progress of the internal audits that continued in 2022 in relation to the ESM's new building project and had exchanges with the external service provider supporting the audit. The Board of Auditors was informed about the relevant framework agreement signed for this purpose between the State of Luxembourg and the ESM that sets forth the terms and conditions for the execution of the project, as well as the parties' duties and obligations in the coming years. As the project is mainly controlled by the State of Luxembourg, the Board of Auditors took note of the consequent limitations on ESM's governance capabilities and on Internal Audit work on the project.

2.3. Ongoing audits of 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 may carry out audit procedures in accordance with Article 30 (3) of the Treaty and Article 24 (4) of the By-Laws.

In this context, the Board of Auditors launched its audit on the ESM's procurement procedures and contracts with third parties with the support of subject matter experts from the Audit Office of the Republic of Cyprus. The main objectives of the audit are to:

- Assess the legal framework applied in contracts signed with third parties;

- Review relevant public procurement policies, to identify any significant changes since the last benchmarking exercise carried out in 2017;
- Examine the implementation stage of the recommendations of the previous Board of Auditors' reports related to procurement procedures and contracts with third parties; and
- Identify possible gaps or weaknesses and make recommendations for further improvement.

The scope of the audit was defined in February 2023 and the audit fieldwork started in March 2023 with a first on-premises visit. The audit should be finalised during the second half of 2023.

Furthermore, an audit on ESM's investment strategy with the support of subject matter experts from the German Federal Court of Auditors is currently scheduled to begin in October 2023.

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 function.

Luxembourg, 15 June 2023

Appendix - composition of the Board of Auditors

According to Article 30 (1) of the Treaty, the Board of Auditors shall 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:

- Ms Helga Berger, appointed upon nomination by the European Court of Auditors (from 17 December 2022). Ms Berger has been serving as Chairperson of the Board of Auditors since 17 January 2023.
- Mr Akis Kikas, appointed upon nomination by the Audit Office of the Republic of Cyprus (from 8 October 2021). Mr Kikas has been serving as Vice-Chairperson of the Board of Auditors since 20 October 2022.
- 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).
- Mr Giovanni Coppola, appointed upon nomination by the Italian Court of Auditors (from 8 October 2022).

