European Stability Mechanism

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

Dear Chairperson,

Thank you for sharing the Board of Auditors' report to the Board of Governors as of 31 December 2020. The independent oversight provided by the Board of Auditors and your annual report are essential elements of the ESM governance and accountability framework. It is notable that despite the travel restrictions and other challenges posed by the Covid-19 pandemic, the Board of Auditors also continued to fulfil its important oversight role during 2020. The ESM management appreciates your report and welcomes its observations and conclusions.

I would like to use this opportunity to provide you and the Board of Governors with the ESM management comments on the report as well as with an overview of the key elements of ESM's audit oversight in 2020.

Overview of the dialogue with the Board of Auditors

In 2020, the Board of Auditors held 14 meetings, of which 12 took place virtually. In these meetings, the Board of Auditors met with the ESM Managing Director, the Secretary General, and other senior members of staff.

During the meetings, the Board of Auditors was, among other matters, updated extensively on the ESM internal organisational response to Covid-19 and the wide-ranging measures that were put in place to protect the health and safety of staff and ensure business continuity of all the organisation's key activities. Furthermore, the Board of Auditors was kept informed of the ESM's policy response to the economic consequences of the pandemic and the development of the Pandemic Crisis Support tool, based on the Enhanced Conditions Credit Line instrument of the ESM Treaty.

The Board of Auditors was also briefed regularly on the progress of the ESM Treaty reform. In this context, the Board of Auditors reviewed and provided input to the audit-related provisions of the draft revised text of the ESM By-Laws. The latter will be submitted for approval to the Board of Governors after the entry into force of the ESM Treaty, as amended by the Amending Agreement. The Board of Auditors was informed of the meetings and decisions of the ESM governing bodies, and other relevant ESM policy issues and developments.

Representatives of various ESM functions, including finance and control, internal audit, risk management, compliance, IT and facilities management, asset and liability management, funding, and investment and treasury, participated in the Board of Auditors' virtual meetings, presented updates on their work and addressed questions on oversight issues raised by the Board of Auditors.

The ESM management, staff, and the external auditor discussed with the Board of Auditors the draft ESM financial statements as at 31 December 2020 and the content of the related disclosures. In line with its mandate, the Board of Auditors monitored and reviewed the external audit processes and their results. It also performed a review of the working papers of the external auditor related to the statutory audit of the ESM financial statements. In preparation of its report in respect of the ESM financial statements, the Board of Auditors exchanged views with the Chairperson of the Board Risk Committee on 10 March 2021.

The Board of Auditors issued its report in respect of the ESM 2020 Financial Statements concluding 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 2020 Financial Statements. The Board of Auditors' Chairperson presented the report on the ESM 2020 Financial Statements to the Board of Directors on 30 March 2021. The Board of Auditors had a further regular exchange of views with the Board of Directors on 3 June 2021, and subsequently presented the Board of Auditors' report on the ESM 2020 Financial Statements and its annual report to the Board of Governors in the annual meeting of the Board of Governors on 17 June 2021.

The ESM internal audit function also met regularly with the Board of Auditors in closed sessions. The Board of Auditors monitored its processes and results, including the annual internal audit plan, the internal audit reports and recommendations, and its quarterly reports on the ESM's progress in addressing outstanding audit recommendations.

In addition to the internal audits performed by the ESM internal audit function and the statutory audit of the 2020 financial statements by the external auditor, in 2020 the Board of Auditors completed an audit on the governance arrangements of the ESM internal committees. The audit was supported by subject matter experts from the Maltese National Audit Office. The audit team conducted extensive

interviews with the Managing Director, the members of the Management Board, and other senior staff. The ESM provided all requested information and supported the effective and timely completion of the audit.

Audit procedures by the internal audit function

In 2020, the ESM internal audit function performed nine audits in accordance with the 2020 annual audit plan. In response to the new challenges brought on by the Covid-19 pandemic, a new audit on ESM's remote work arrangements was conducted, replacing another previously planned audit.

The internal audit function had full, unrestricted, and confidential access to the Board of Auditors and confirmed that there were no impairments to its independence and objectivity in 2020.

On 23 November 2020, the ESM Internal Audit Charter was approved by the Board of Directors. The Internal Audit Charter was first established by the ESM Managing Director in 2013 and subsequently updated in 2015 and 2018. By bringing the Internal Audit Charter to the Board of Directors for approval, the ESM implemented a recommendation of the Board of Auditors and guidance from the Institute of Internal Auditors.

Audit procedures by the independent external auditor

The Board of Governors appointed Ernst & Young Société anonyme, Luxembourg ("Ernst & Young") as independent external auditor of the ESM on 15 June 2017 for a term of three years. On 11 June 2020, the Board of Governors extended the term of Ernst & Young for an additional and final period of three years until 15 June 2023.

Ernst & Young carried out the statutory audit of the ESM 2020 Financial Statements and on 30 March 2021 presented its report to the Board of Directors. In its report, Ernst & Young confirmed that the financial statements gave a true and fair view of the financial position of the ESM as of 31 December 2020. Furthermore, Ernst & Young confirmed that no matter came to its attention that would require making recommendations in its Management Letter.

The external auditor also confirmed that the statutory audit was conducted in accordance with the requirements of Regulation No 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, the International Standards on Auditing as adopted for Luxembourg by the "Commission de Surveillance du Secteur Financier", and in compliance with the relevant ethical requirements regarding its independence. The external auditor noted that it was granted unlimited access to documents and ESM staff and had good cooperation by the ESM management, despite the remote performance of the audit. The external auditors' report was presented to the Board of Governors at the annual meeting on 17 June 2021 and is publicly available on the ESM website, as part of the *ESM 2020 Annual Report*.

ESM Internal Control Framework

The extensive audit oversight of the ESM is complemented by a comprehensive system of internal controls, which are embedded in the daily operations of the ESM. The ESM internal controls, comprising entity-level, process-level, and information technology controls, are consistent with the nature, complexity, and risks inherent in ESM activities. The internal controls are subject to scrutiny by ESM management and regular independent review by the ESM internal audit function, the external auditor, and the Board of Auditors.

As part of the ESM Internal Control Framework, ESM management performs an annual self-evaluation of internal controls. The outcome of the self-evaluation, together with the observations of the risk management, compliance, and internal audit functions, is presented in an annual management report on internal controls, which is shared with the Board of Auditors, the external auditor, and the Board Risk Committee. The 2020 management report on internal controls concluded that the ESM maintained an overall effective system of internal controls as at 31 December 2020.

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Management comments on the Board of Auditors' annual report

The ESM management appreciates the recommendations and conclusions noted in the *2020 Board of Auditors' annual report to the Board of Governors*. Furthermore, the ESM management welcomes the overall conclusion of the Board of Auditors' audit report on ESM internal committees that the structure, composition, and governance of the ESM internal committees is conducive to their function. It also takes note of the recommendations for further improvement issued by the Board of Auditors. In response to these recommendations, the ESM management is committed to undertaking the necessary actions and formalising in writing the established practice for setting up and revising the terms of reference of internal committees. The ESM management will also perform periodic landscape reviews of the roles of all internal committees, which will complement the current ad hoc reviews performed in response to specific institutional needs. Lastly, periodic performance assessments of the internal committees will be implemented to identify areas for improvement on an ongoing basis.

In closing

I would like to confirm that the ESM management remains fully committed to continuously and actively engaging with and supporting the work of the Board of Auditors, including by facilitating its periodic exchanges with the ESM governing bodies. The Board of Auditors' annual report to the Board of Governors provides important observations and conclusions, which are appreciated and welcomed by the ESM management.

Lastly, I would like to use this opportunity to thank in particular Irena Petruškevičienė, appointed upon proposal of the Chairperson of the Board of Governors, and Noel Camilleri, appointed upon nomination by the Maltese National Audit Office, for their great commitment and service as members of the Board of Auditors, since their non-renewable mandates at the Board of Auditors will expire on 7 October 2021. In the course of 2021, the Board of Governors will appoint two new members to the Board of Auditors – one upon nomination by the supreme audit institution of Cyprus (based on the system of rotation among the supreme audit institutions of the ESM Members, established in the ESM By-Laws), and another member upon proposal by the Chairperson of the Board of Governors, Paschal Donohoe.

I look forward to continuing the constructive exchange with the Board of Auditors in 2021 and beyond for the benefit of the ESM and its Members.

17 June 2021

Klaus Regling
Managing Director