



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 2021. The independent oversight provided by the Board of Auditors and your annual report to the Board of Governors are essential elements of the ESM governance and accountability framework. The ESM management acknowledges your report and welcomes its observations and conclusions.

I would like to provide you and the Board of Governors with the ESM management comments on your report and to recall the key elements of ESM's audit oversight that were in place in 2021.

Independent oversight by the Board of Auditors

In 2021, the Board of Auditors held eight meetings, of which six 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 from various functions, including corporate governance, finance and control, internal audit, risk management, compliance, asset and liability management, investment and treasury, and IT and facilities management.

During these meetings, the Board of Auditors was informed of the meetings and decisions of the ESM governing bodies and other relevant ESM policy issues and developments including, among other topics, the internal organisational measures of the ESM to mitigate the risks related to the Covid-19 pandemic; the progress with the ratification of the amended ESM Treaty, which was signed by the ESM Members in January and February 2021; the project for the construction of the new ESM administrative building and related governance and audit arrangements; the ESM's balance sheet resilience; ESM's capital preservation efforts and derivative operations; the ESM's debt sustainability analysis methodology; and various Board-level and internal policies, including the ESM Code of Conduct, as amended by the Board of Directors in February 2021.

Furthermore, the Board of Auditors discussed with the ESM management, staff, and the external auditor the draft ESM financial statements as at 31 December 2021 and related disclosures, including the disclosure of significant events taking place after the reporting period, such as the war on

Ukraine. In preparation of its report in respect of the ESM 2021 financial statements, on 11 March 2022 the Board of Auditors also exchanged views with the Chairperson of the ESM Board Risk Committee.

In its report in respect of the ESM 2021 financial statements, 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 2021 financial statements. The Board of Auditors' Chairperson presented the report on the ESM 2021 financial statements to the Board of Directors on 28 March 2022. The Board of Auditors had a further regular exchange with the Board of Directors on 8 June 2022, and subsequently presented the Board of Auditors' report on the ESM 2021 financial statements and its annual report to the Board of Governors at the annual meeting of the Board of Governors on 16 June 2022.

In line with its mandate, the Board of Auditors regularly monitored and reviewed the external audit processes and their results and performed a review of the working papers of the external auditor, Ernst & Young, related to the statutory audit of the ESM 2021 financial statements. Following its review of the external audit processes performed by Ernst & Young, the Board of Auditors recommended the ESM review its accounting manual and related accounting policies to ensure they remain complete and consistent with generally accepted accounting principles, taking into account ESM needs and best practices of comparable institutions. The Board of Auditors also recommended the ESM keep up with the developments related to sustainability reporting. The ESM confirmed to the Board of Auditors its appreciation of these recommendations and commitment to address them.

The Board of Auditors also took note of the upcoming retendering of the contract for the ESM external auditor for the financial years 2023–2025, and reiterated the importance of maintaining its access to the working papers of the external auditor. In preparing the documents for the public procurement procedure for the selection of a new external auditor, the ESM has ensured that all requirements pursuant to the ESM Treaty and By-Laws are properly reflected, including the role of the Board of Auditors in monitoring and reviewing the external audit processes and their results and the Board of Auditors' access to all documents and information necessary for the fulfilment of its tasks. Similar to prior tenders for selection of ESM

external auditors, the Board of Auditors is invited to serve as observer to the selection process.

The Board of Auditors also met regularly with the ESM internal audit function in closed sessions. It monitored its processes and results, including the 2021 annual 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 audits performed by the ESM internal audit function and the statutory audit of the ESM 2021 financial statements by the external auditor, the Board of Auditors also conducted an audit on ESM recruitment processes on the basis of Article 30 (3) of the ESM Treaty and Article 24 (4) of the ESM By-Laws. The audit was supported by subject matter experts from the European Court of Auditors, who conducted the field work in the last quarter of 2021 and concluded the audit work in the first quarter of 2022. The main objective of the audit was to assess whether the ESM recruitment framework is appropriately rigorous and robust.

The audit report concluded that "the ESM has in place a recruitment system able to attract talented staff in a short period of time". At the same time, the report contained several recommendations, most of which relate to further formalisation of the existing recruitment framework. The audit provided an independent review of the recruitment processes at the ESM at the most granular level, and the ESM management is appreciative of the conclusions and recommendations related to further definition of the ESM recruitment strategy, applicable rules and procedures, delegation framework, and information made available to unsuccessful candidates, among others. The ESM management confirmed its commitment to implement these recommendations, which are in line with ESM's own continuous optimisation efforts.

Audit procedures by the internal audit function

In 2021, the ESM internal audit function performed 10 audits in accordance with the 2021 annual audit plan and postponed one. 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 2021.

In 2021, the internal audit function was subject to an external quality assessment, as required by the International Standards for the Professional Practice of Internal Auditing and the ESM Internal Audit Charter. The external assessment concluded: "the internal audit function at ESM is in general conformity with the International Standards for the Professional Practice of Internal Auditing and the Institute of Internal Auditors' Code of Ethics. The principles of the Standards are applied in a professional and pragmatic way". The results of the external assessment were presented to the ESM Managing Director and to the Board of 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 period of three years until 15 June 2023.

Ernst & Young carried out the statutory audit of the ESM 2021 financial statements and on 28 March 2022 presented its report to the Board of Directors. In its report, Ernst & Young confirmed that the financial statements give a true and fair view of the financial position of the ESM as of 31 December 2021. Furthermore, Ernst & Young confirmed that no matter came to its attention that would require making recommendations in a 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 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. The external auditor's report was presented to the Board of Governors at the annual meeting on

16 June 2022 and is publicly available on the ESM website, as part of the *ESM 2021 Annual Report*.

Due to the mandatory rotation of the ESM external auditor every six years, as required by Article 22 (2) of the ESM By-Laws, the ESM is in the process of conducting a public procurement procedure for the selection of a new external auditor for the financial years 2023–2025.

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 the 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, the 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 2021 management report on internal controls concluded that ESM maintained an overall effective system of internal controls as at 31 December 2021.

In closing

ESM management is committed to continuing its regular dialogue with the Board of Auditors and providing any support, document, or information that is needed for the implementation of its tasks. The Board of Auditors' annual report to the Board of Governors offers important observations and recommendations, which are appreciated and welcomed by ESM management. We are already in the process of addressing the recommendations provided by the Board of Auditors in the context of its work and its audit on ESM recruitment processes.

Lastly, I would like to use this opportunity to thank the Board of Auditors and in particular Mr Tommaso Fabi, whose non-renewable mandate at the Board of Auditors expired on 31 March 2022, for his great commitment and service as a member of the Board of Auditors. I would also like to welcome the new members of the Board of Auditors appointed by the Board of Governors: Mr Akis Kikas, appointed as of 8 October 2021 upon nomination by the supreme audit institution of Cyprus; Mr Jochen Wenz, appointed as of 8 October 2021 upon proposal by the Chairperson of the Board of Governors; and Ms Lucia Kašiarová, appointed as of 25 April 2022 also upon proposal by the Chairperson of the Board of Governors.

I look forward to continuing our constructive exchanges with the Board of Auditors in 2022 for the benefit of the ESM and its Members.

16 June 2022

Klaus Regling
Managing Director