

European Stability Mechanism



ESM MANAGEMENT COMMENTS ON THE BOARD OF AUDITORS' ANNUAL REPORT TO THE BOARD OF GOVERNORS

for the period ended 31 December 2016

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 2016.

The ESM management takes note of the positive conclusion of the report and views this as recognition of the sustained efforts undertaken over the past years in establishing the ESM as a fully matured institution. Since the inauguration of the ESM on 8 October 2012, the ESM management had placed critical importance into meeting the expectations of the Board of Auditors. As such, the ESM sought to implement all key recommendations issued in relation to the past audits of the Board of

Auditors performed in the areas of Finance and Control, Risk Management, Lending, Funding, and Investment. This included the establishment of a comprehensive Internal Control Framework, the further alignment of the ESM Procurement Framework with the EU Directive on Public Procurement, as well as the amendment of the Early Warning System procedure, which monitors the ability of beneficiary Member States to cover upcoming payments to the ESM.

These achievements reflect the hard work and strong commitment of the ESM staff and management.

OVERVIEW OF THE DIALOGUE WITH THE BOARD OF AUDITORS

Against this background, I would like to use this opportunity to provide you with a detailed overview of the ESM engagement with the Board of Auditors.

During the past year, the ESM management met on a regular basis with the Board of Auditors, continuing their collaborative relationship. In 2016, the Board of Auditors held eight meetings and met once with the Board of Directors. 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. To date in 2017, the Board of Auditors has held three meetings.

During these meetings, the Board of Auditors was regularly updated on ESM activities, the work of the ESM governing bodies, and other relevant issues and developments. Key staff members and the ESM management devoted considerable time and effort to discussing relevant issues, submitting written notes in response to questions raised, and providing any other 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 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 of 31 December 2016 (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 is included in the ESM 2016 Annual Report along with the Financial Statements and the external auditor's report.

In 2017, the ESM performed a competitive procurement procedure for the selection of a new independent external auditor for the financial years 2017–2019. Two members of the Board of Auditors acted as observers to this process.

According to Article 22 (2) of the ESM By-Laws, there shall be a mandatory rotation of the external auditors every six years. The ESM Board of Governors had appointed PricewaterhouseCoopers, Société coopérative ("PwC") as the ESM external auditor on 8 October 2012. As such, PwC was no longer eligible to participate in the procurement process.

AUDIT PROCEDURES CONDUCTED IN 2016

Audit procedures conducted by the Board of Auditors

The ESM is subject to significant independent audit oversight throughout the year, as well as at year-end. In addition to the annual statutory audit by the independent external auditor, the Board of Auditors carried out an independent audit of the ESM Investment Operations in accordance with Article 30 (3) of the ESM Treaty.

In line with Article 24 (5) of the ESM By-Laws, the Board of Auditors designated two subject matter experts from the Irish Supreme Audit Institution to support its audit work. The ESM provided all the necessary cooperation and support required for the successful completion of the audit.

Audit procedures conducted by the Internal Audit function

During the past year, the Internal Audit function performed six audits and reported that the 2016 Audit Plan approved by the ESM management and presented to the Board of Auditors was completed.

For each audit performed, the Internal Audit function also tested the design and operating effectiveness of internal controls for the activities under scope. In addition, the Internal Audit function also reviews the ESM entity level controls on an annual basis.

No high-risk internal audit recommendations were outstanding as of year-end 2016. The ESM management will continue its sustained efforts to ensure the timely closure of internal audit recommendations, including those classified as medium and low risk.

The Internal Audit function had full unrestricted access to the Board of Auditors and confirmed that there were no impairments to the function's independence and objectivity throughout the year.

There were seven meetings between the Internal Audit function and the Board of Auditors in 2016 and three further meetings to date in 2017. The Internal Audit function reported to the Board of Auditors on the results of the internal audits conducted; the progress in implementing the Annual Audit Plan; and, on a quarterly basis, the implementation status of the internal audit recommendations as well as the recommendations issued by the Board of Auditors and the independent external auditor.

Audit procedures conducted by the independent external auditor

The independent external auditor PwC carried out the 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 2016, and of the results of its operations and its cash flows. The independent external auditor conducted the audit in accordance with the International Standards on Auditing as adopted for Luxembourg by the Commission de Surveillance du Secteur Financier.

As part of its annual audit, PwC 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. PwC also confirmed that unlimited access to documents and staff had been granted and noted good cooperation by the ESM management.

Furthermore, no findings or recommendations were issued in the 2016 PwC Management Letter. As an annex to the Management Letter, the external auditor also issued the annual Special Topic Report, covering an additional area related to the financial reporting process in further depth. No exception was identified in this regard.

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 institution and reflects the nature, complexity, and risks inherent in ESM activities. It comprises entity level, process level, and information technology controls, consistent with the nature, complexity and risks inherent in ESM activities. The ESM internal controls cover all ESM departments and are underpinned by the three lines of defence governance model established by the Board of Directors in the High Level Principles for Risk Management.

Internal controls are subject to scrutiny by management and periodic independent review by the Internal Audit function as well as the external auditor.

On such basis, the Managing Director issues an annual management report on the effectiveness 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 manage-

ment action plans to address them. Based on its 31 December 2016 assessment, the ESM management found no material or significant deficiencies in internal controls. Also, it identified no instances of fraud in 2016.

Conclusion

In closing, I would like to note that ESM is appreciative of the ongoing constructive feedback and support that the Board of Auditors has provided over the past years. Going forward, the ESM 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 continues to be fully confident that its policies, procedures and staff will enable the institution to successfully deliver on the ESM mandate and ensure effective control mechanisms.

I look forward to continuing our good working relationship in 2017 and beyond.

Sincerely,

Klaus Regling
Managing Director