

Board of Auditors' Annual Report to the Board of Governors

for the period ended 31 December 2017

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. 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.

The Board of Auditors is an independent body. It inspects the ESM accounts and verifies that the operational accounts and the balance sheet are in order. Furthermore, it carries out independent audits in relation to the regularity, compliance, performance, risk management of the ESM 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 2017. 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 met on seven occasions in 2017, during which it held regular discussions with the ESM Management in relation to institutional developments and oversight questions.

During these 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, met regularly with the internal and external auditors. 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 Chairperson of the Board of Auditors met with the Board of Directors on 9 June 2017.

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 to give briefings on the work and conclusions of the Board of Auditors. Furthermore, the Board of Auditors met with the

Board Risk Committee on 27 November 2017 to better understand each other's work.

From 31 December 2017 to the date of this report, the Board of Auditors continued its work as set out above, and has held a further five meetings.

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 procurement framework (with the assistance of subject matter experts from the European Court of Auditors). The audit work was finalised in July 2017.
 - external consultancy services (with the assistance of subject matter experts from the French Supreme Audit Institution). The audit work was finalised in April 2018.
 - the ESM Internal Control Framework (with the assistance of subject matter experts from the European Court of Auditors). The audit work was well advanced at the time of writing of this report in May 2018.
- 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 2017 as drawn up by the Board of Directors on 27 March 2018. 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 2017 amount to EUR 797.0 billion and consist on the assets side mainly of loans and advances to euro area member states (EUR 76.2 billion), debt securities (EUR 20.9 billion), subscribed capital called but not paid (EUR 175.1 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 shareholders' equity amounts to EUR 707.0 billion. The total liabilities (EUR 90.0 billion) are composed mainly of debts evidenced by certificates (EUR 89.2 billion). The net profit for the financial year amounts to EUR 68.6 million, mainly the result of interest receivable and similar income (EUR 1.2 billion), and net profit on financial operations (EUR 27.2 million), offset by interest payable and similar charges (EUR 1.1 billion) and general administrative costs (EUR 60.2 million).

A notable feature of the results is the impact of decreased or sometimes negative received interest and yields on assets as well as the lower profitability of financial operations, which have an important impact on the economic outturn. The notes of the presentation indicate that some of these effects have been offset in 2018 by a transfer of EUR 86.7 million from the French Republic, following the approval of the French Parliament. This transfer was made arising from a political commitment to return to the ESM the equivalent of the negative interest paid on deposits held at Banque de France in 2017 and in anticipation of a similar action to be taken by other ESM Members.

- monitored and reviewed external audit processes performed by Ernst & Young Société anonyme. This included a review of their risk assessments, audit working papers and documentation with the assistance of a subject matter expert from the European Court of Auditors. Furthermore, the Board of Auditors reviewed the report addressed to the Board of Auditors which is issued by the external auditor in compliance with EU Regulation 537/2014, describing the audit process, scope and its results.
- met with the ESM Managing Director, members of the Management Board and senior staff, to discuss and review relevant issues and developments. Particular focus was placed on the areas of risk inherent to the operations of the ESM.
- 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.

3. In closing

The ESM, for the period under review, was in its fifth 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.

The Board of Auditors will continue to monitor the implementation of its audit recommendations and those of the Internal Audit Division.

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 2017, 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)
- Mr François-Roger Cazala, nominated by the Cour des Comptes of the French Republic (from 8 October 2016). Mr Cazala has been serving as Vice-Chairperson of the Board of Auditors since 21 February 2017
- Mr Kevin Cardiff, nominated by the European Court of Auditors (from 17 December 2016). Mr Cardiff has been serving as Chairperson of the Board of Auditors since 21 February 2017