



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2007/8 INSPECTION OF ERNST & YOUNG LLP

8TH DECEMBER 2008

This report is issued by the Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), part of the Financial Reporting Council. It has been approved for publication by the Oversight Board.

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1 Scope, objectives and background information

1.1 Introduction

This report sets out the principal findings arising from the inspection of Ernst & Young LLP (“Ernst & Young” or “the firm”) carried out by the Audit Inspection Unit (“the AIU”) of the Professional Oversight Board (“the Oversight Board”), part of the Financial Reporting Council (“the FRC”), in respect of the year to 31 March 2008 (“the 2007/8 inspection”). Our inspection was conducted in the period from June 2007 to February 2008 (referred to as “the time of our inspection”).

This report is based on the AIU’s more detailed private report on its inspection of the firm to the Audit Registration Committee (“the ARC”) of the Institute of Chartered Accountants in England and Wales (“the ICAEW”) with whom the firm is registered for audit purposes. The AIU currently inspects the largest audit firms, including Ernst & Young, annually¹. The 2007/8 inspection was the AIU’s fourth inspection of the firm. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU’s 2007/8 report to the ARC, finalised in August 2008, recommended that the firm’s registration to conduct audit work should be continued.

This is the first year the AIU has reported publicly on individual firms. In the past the AIU issued an annual public report in which the principal findings arising from its inspections of the major audit firms in the UK were dealt with on an anonymous and aggregated basis.

The AIU exercises judgment in determining those findings which it is appropriate to include in a public report, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU’s overall inspection programme for the relevant year.

The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm’s client base. An issue reported in relation to a particular firm might also apply to other firms without having arisen in the course of the AIU’s inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits is selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm’s audit work.

¹ The Companies Act 2006, as amended with effect from 6 April 2008 by the Statutory Auditors and Third Country Auditors Regulations 2007, requires that full scope inspections of those audit firms conducting more than ten audits within the scope of independent inspection (as determined by the Professional Oversight Board) are undertaken at least every three years.

All findings requiring action set out in this report have been discussed with the firm together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU during its next inspection of the firm.

The Oversight Board undertook to publish all the reports for the 2007/8 cycle of inspections on a single date. The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there is necessarily a significant period of elapsed time between completion of the AIU's inspection fieldwork at firms and the publication of reports on the inspection findings.

The firm was invited to provide a response to this report for publication. The firm's response is set out in Appendix A.

The AIU acknowledges the co-operation and assistance received from the partners and staff of Ernst & Young in the conduct of the 2007/8 inspection. The findings arising from our reviews of individual audit engagements took longer to finalise than was the case for other firms. We have therefore discussed with the firm how the process can be improved for the future.

1.2 Scope and objectives

The overall aim of the FRC is to promote confidence in corporate reporting and governance. One of the strategic outcomes contributing to this aim is for the users of audit reports to be able to place a high degree of reliance on audit opinions, including whether financial statements show a true and fair view. The AIU's programme of inspections is designed to contribute to the achievement of this strategic outcome.

Our inspections of the major audit firms, on which we report publicly, include a review of the firms' policies and procedures supporting audit quality and a review of the quality of selected audits of listed and other major public interest entities that fall within the scope of independent inspection, as determined each year by the Oversight Board.

We review firms' policies and procedures in the following areas:

- Leadership, strategy and communications
- Performance evaluation, promotions and remuneration
- Other human resource matters
- Client risk assessment and acceptance and continuance
- Consultation and review
- Audit quality monitoring

- Independence and ethics
- Audit methodology

Our reviews of individual audits include an assessment of the appropriateness of significant audit judgments exercised and the sufficiency and appropriateness of the audit evidence obtained.

Our inspections include, but are not restricted to, an assessment of compliance with the requirements of relevant standards and other aspects of the regulatory framework for auditing. These comprise the auditing standards and ethical and quality control standards for auditors issued by the FRC's Auditing Practices Board (APB)² and other relevant requirements under the ICAEW's Audit Regulations³. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken. (The APB issued revised Ethical Standards in April 2008 which are effective for audits of financial statements for periods commencing on or after 6 April 2008.)

We seek to identify areas in which improvements are, in our view, required to safeguard audit quality, including matters relating to compliance with regulatory requirements, and to agree an action plan with the firm designed to achieve these improvements. We also assess the extent to which the firm has addressed the findings and recommendations arising from its last AIU inspection.

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. Our inspections are not designed to, nor would it be possible to, identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

We reviewed the quality of ten individual audit engagements undertaken by the firm. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between December 2006 and March 2007. Our reviews covered selected aspects of the audit only. In addition, we undertook two follow up reviews to assess the extent to which our prior year findings had been addressed in the following year's audits.

² International Standards on Auditing (UK and Ireland). APB Ethical Standards and International Standard on Quality Control (UK and Ireland) 1.

³ The Audit Regulations are issued jointly by The Institute of Chartered Accountants in England and Wales, The Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland.

The monitoring units of the professional accountancy bodies in the UK who register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection by the AIU but within the scope of audit regulation in the UK. Their work, which is overseen by the Oversight Board, covers audits of UK incorporated companies and certain other entities which do not have any securities listed on the main market of the London Stock Exchange (“a full listing”) and whose financial condition is not otherwise considered to be of major public interest. All matters raised in this report are based solely on work carried out by the AIU.

This report has been prepared for general information only. The information in this report does not constitute professional advice and should not be acted upon without obtaining specific professional advice.

To the full extent permitted by law, the FRC, the Oversight Board, the AIU and their employees and agents accept no liability and disclaim all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this report or for any decision based on it.

1.3 Background information on the firm

Ernst & Young is a UK limited liability partnership and is the UK member firm of the Ernst & Young global organisation (“EYG”) which has developed policies and procedures, including an audit methodology and audit support system, for use by member firms. In June 2008, the EYG member firms in the UK, Europe, the Middle East, India and Africa announced that they would be merging.

Ernst & Young operates from 19 offices in the UK through three service lines, being Assurance and Advisory Business Services (“Assurance”), Tax and Transaction Advisory Services. All statutory audit work is conducted through the Assurance service line which comprises three geographic business units and eight industry groups, including three relating to financial services.

For the year ended 30 June 2007, the firm’s turnover was £1,226 million, of which £636 million related to the Assurance service line⁴. At 31 May 2007, the firm had 9,989 members of staff and 478 partners. The firm had a total of 222 persons authorised to sign audit reports, of whom 154 were partners and 68 audit directors (employees)⁵.

The AIU estimates that the firm had 347 audit clients within the scope of independent inspection by the AIU as at the 2007/8 reference date of 27 February 2007. Of these audit

⁴ As disclosed in the firm’s annual report for the year ended 30 June 2007. An analysis of fee income between audit and non-audit fees is not publicly available.

⁵ As disclosed in the annual return to the ICAEW as at 31 May 2007.

clients AIU records show that 249 had a full listing or were listed on the AIM market of the London Stock Exchange⁶, including 15 FTSE 100 audit clients and 39 FTSE 250 audit clients.

⁶ The firm also had other AIM listed audit clients below the threshold for inclusion within scope.

2 Findings

2.1 Overview

On the basis of our inspection, we consider that Ernst & Young's strategy, communications, policies and procedures evidence its commitment to quality and continuous improvement in the conduct of its statutory audit work.

We reviewed the firm's policies and procedures and, in our view, they were appropriate to the size of the firm and the nature of its client base. During the year the firm made significant changes to its partner remuneration model in order to improve the linkage between quality and remuneration and render the process more transparent. We were advised that, under the revised arrangements, first implemented by the firm for the sharing of profits for the year ended 30 June 2008, partners are not eligible to participate in the firm's pool of performance-related units relating to quality unless they have exceeded the firm's quality standards. In our view, these changes support the firm's quality agenda. We identified the need for improvement in certain other areas of the firm's policies and procedures, such as ensuring the completion of appraisals for senior managers, details of which are set out in Section 2.2 on Quality Control and Section 2.3 on Independence and Ethics.

In relation to reviews of individual audits, we have generally reported our findings on the basis of themes arising or issues of a similar nature identified across a number of audits. We believe that the number of the firm's audits reviewed by us makes it appropriate to report on this basis.

We were generally satisfied, subject to our comments in Section 2.4.3, with the basis on which significant audit judgments were made on the ten audits reviewed by us. In our view, audit work was generally performed to a good or acceptable standard and, in relation to one listed entity, to a very good standard. The overall findings arising from our review of individual audits are set out in Section 2.4; these include areas where improvements are, in our view, needed in order to enhance audit quality.

The two follow up reviews we conducted showed that the issues we raised in the previous year had been addressed on those audits.

The firm has implemented the recommendations we made following our inspection last year by providing the required training and/or guidance and taking other steps as appropriate. We noted that a few issues continued to recur although some of the individual audits we reviewed were carried out prior to the relevant training and/or guidance being provided. We believe these issues should remain the subject of audit training until the required improvements are achieved.

The principal findings arising from our review of the firm's policies and procedures supporting audit quality and the quality of the individual audits selected by us for review are set out below under three broad headings: Quality Control (Section 2.2); Independence and Ethics (Section 2.3); and Audit Performance (Section 2.4).

2.2 Quality control

This section covers our review of the following aspects of the firm's system of quality control for audit engagements:

- 2.2.1 Leadership, strategy and communications
- 2.2.2 Performance evaluation, promotions and remuneration
- 2.2.3 Other human resource matters
- 2.2.4 Client risk assessment and acceptance/continuance
- 2.2.5 Consultation and review
- 2.2.6 Audit quality monitoring

2.2.1 Leadership, strategy and communications

Ernst & Young is managed by a Leadership Team which is appointed by the Chairman and has full authority to deal with the firm's operational management and to develop and implement strategy. An elected Council exercises governance over the Leadership Team.

The firm's strategic objective is to provide 'Seamless, consistent, high-quality client service, worldwide' and this quality agenda is applied in its dealings with its clients, its people and its own operations.

We met with the Head of Quality and Risk Management and the Head of Operational and Finance Services, both of whom were members of the Leadership Team, and the Head of Assurance and Advisory Business Services to consider the firm's strategy for audit services and assess the importance the firm places on audit quality.

We reviewed the firm's strategy and quality agenda insofar as they related to audit work and the firm's communications on audit related matters, which are made on a regular basis and by a variety of means, from which it was clear that the firm attaches appropriate importance to high quality audit work.

2.2.2 Performance evaluation, promotions and remuneration

Performance evaluation

The performance of audit partners and staff is evaluated on an annual basis. Each partner and member of staff prepares a self-appraisal and his/her performance is evaluated by a more senior partner or manager who considers evidence on performance against a range of contribution, compliance and quality measures. These performance measures for partners and directors are monitored throughout the year by the firm's Quality and Risk Management department, and include a wide range of matters such as attendance at mandatory training, timely completion of independence confirmations, findings arising from pre-issuance reviews (see Section 2.2.5), the results of the firm's own Audit Quality Review (see Section 2.2.6) and findings arising from the review of individual audits by the AIU.

We reviewed the appraisal process and the appraisal forms for a sample of audit partners, audit directors and senior managers whose audits were reviewed in the previous year either by the firm in its Audit Quality Review or by the AIU. We considered the appraisal process and the appraisal forms for the sample of audit partners we reviewed to have been conducted to a very good standard. However, we noted that the appraisal forms for some of the senior managers within our sample were incomplete in a number of respects.

Promotions

We reviewed the partner promotion process and the files of supporting evidence for the candidates put forward in the firm's 2007 partner admission process for the Assurance service line. In our view, the process for the consideration of the candidates was thorough and gave appropriate weight to quality issues.

Remuneration

During the year, the firm introduced revised arrangements for partner remuneration in order to improve the linkage between quality and remuneration and render the process more transparent. We were advised that, in order to underscore the importance the firm places on quality, under the revised arrangements partners are not eligible to participate in the firm's pool of performance-related units relating to quality unless they have exceeded the firm's quality standards. At the time of our inspection, the revised arrangements had not been fully implemented. We expect to review their implementation during our 2008/9 inspection of the firm.

2.2.3 Other human resource matters

Audit training and communications

The firm reviews technical and regulatory developments on a continuous basis, liaises as necessary with other technical groups in EYG and provides regular training to audit partners and qualified staff by means of core training courses, newsletters, bulletins, webcasts and its own intranet.

During the year, the firm introduced a new audit support system, which was the focus of extensive training prior to its adoption for December 2007 year ends. In addition, the firm ran a training course for audit partners and qualified staff dealing exclusively with the findings from the AIU's 2006/7 inspection and the firm's 2007 Audit Quality Review. Attendance by partners and qualified staff at mandatory training courses is monitored for annual appraisal purposes by the Quality and Risk Management department and business units respectively.

We met with a number of partners from the technical departments and reviewed some of the firm's audit training material and the credit crunch communications noted below.

Credit crunch communications

Following the turmoil in financial markets which started in summer 2007, the firm worked closely with EYG and provided extensive and timely information to audit partners and staff. The aim of the communications was to heighten the level of awareness amongst partners and staff and to provide guidance on how to identify and address certain conditions and trends.

A panel of specialist partners was established for consultation and regular feedback meetings for audit partners were held to ensure all relevant issues were being properly addressed.

2.2.4 Client risk assessment and acceptance and continuance

Firms are required to have policies and procedures in place to provide them with assurance that client integrity, compliance with ethical requirements and their competence, capabilities and resources are considered before they decide whether to accept or continue an audit engagement⁷.

For risk assessment purposes, audit engagement partners are responsible for considering the inherent risk to the firm of each of his/her audit clients and allocating them to one of

⁷ International Standard on Quality Control (UK and Ireland) 1, paragraph 28

three risk bands as appropriate. The purpose of such risk banding is to ensure that increased levels of review and sign-off are carried out for those clients that are deemed to pose higher audit risk to the firm. The risks to the firm posed by clients allocated to the highest risk band are monitored closely by a board established for the purpose which meets twice a year to consider such clients in each business unit. The risk banding of audit clients is reviewed by the Compliance Partner at least annually.

The acceptance of new audit clients is managed by the proposed engagement partner in conjunction with the Compliance Partner and the Quality and Risk Management department who carry out the necessary conflicts, independence and anti-money laundering procedures. The continuance of audit clients is managed by individual audit engagement partners.

We reviewed the acceptance and continuance records in respect of a sample of audit clients, on the basis of which we considered the firm to have effective procedures in place.

2.2.5 Consultation and review

Engagement quality control review

Firms are required to have policies and procedures in place requiring an engagement quality control review to be undertaken for all audits of financial statements of listed entities and other audits meeting specified criteria.⁸ For such clients, Ernst & Young carries out an engagement quality control review and a pre-issuance technical review as described below.

Engagement quality control reviews are carried out by experienced audit partners who are independent of the audit teams. The firm's guidance requires audit engagement partners to involve such independent partners at the planning and completion phases of the audit and to consult them as necessary throughout the progress of the audit.

We considered the involvement of the engagement quality control review partners in all the individual audit engagements we reviewed and found they generally performed their review in accordance with the firm's policies and procedures.

Pre-issuance technical reviews

The firm's technical department undertakes pre-issuance reviews of the financial statements for all listed audit clients, as well as for all cross-border filings. Most of the reviews are completed in the firm's offices, but personnel from the technical department sometimes carry out their reviews at clients' premises. For other clients, responsibility to

⁸ International Standard on Quality Control (UK and Ireland) 1, paragraph 60.

obtain a pre-issuance review rests with the engagement partner. From 2008, the technical department will extend its role to include attendance at audit planning meetings for major listed audit clients in order to identify as early as possible in the audit process areas of audit and accounting complexity. We consider this to be a positive development.

We met the partner in charge of the technical department to ensure we had a proper understanding of the scope, depth and effectiveness of the department's role. We considered the technical department's work in respect of all the individual audits we reviewed and found the firm to have comprehensive consultation and review procedures.

2.2.6 *Audit quality monitoring*

Firms are required to have monitoring procedures in place and to review a selection of completed audit engagements to provide them with assurance that their system of quality control is adequate, operating effectively and complied with in practice. Such monitoring is required to be undertaken at least annually.⁹

EYG requires member firms to carry out an Audit Quality Review in order to uphold and enhance the quality of their audit work. In the UK, the Audit Quality Review is required to cover all audit partners over a three year period and consists of two elements. The first relates to a review of compliance with certain of the firm's policies and procedures applicable to the audit practice; and the second relates to an assessment of the quality of the firm's audit work by reviewing a sample of individual audit engagements.

Ernst & Young carried out its 2007 Audit Quality Review between June and July 2007 and covered certain business groups in London and five regional offices as noted below.

In relation to compliance with the firm's policies and procedures, the main areas reviewed related to client acceptance and continuance, consultation, staff recruitment and other personnel related matters. No matters of significance were noted.

In relation to the quality of individual audit engagements, 106 such engagements were reviewed and graded, on the basis of five grades, from very good quality to unacceptable.

We reviewed the guidance, the work programme used by reviewers, the results of the review and the firm's planned actions. In our view, the AQR process was well planned and rigorous. However, there were certain areas dealt with in the guidance for reviewers that, in our view, were of sufficient importance to merit separate work steps in the work programme. We considered the firm took appropriate steps in relation to those audit

⁹ International Standard on Quality Control (UK and Ireland) 1, paragraph 74 and the ICAEW's Audit Regulations.

partners and/or audit directors whose audit engagements were deemed by the firm to be less than satisfactory.

The overall results of the 2007 Audit Quality Review were communicated to the Head of Quality and Risk Management and all offices. In addition, the overall results and the firm's planned actions were communicated to the firm's Leadership Team and EYG. On the basis of our review, we considered the firm to have effective audit quality monitoring processes in place.

2.3 Independence and ethics

2.3.1 *Ethical policies and consultation*

Firms are required to have policies and procedures in place designed to achieve compliance with the Ethical Standards issued by the Auditing Practices Board together with relevant ethical pronouncements issued by the professional body with which the firm is registered.

The firm's ethical policies for the audit practice are set out in the Assurance Practice Manual which is available electronically to all audit partners and staff. During the year the firm reviewed its mapping of its ethical policies against the requirements of the Ethical Standards and no changes of any note were identified as being required. The firm provides web-based training on its ethical requirements including such matters as business relationships, independence and compliance with the firm's processes.

Consultation on ethical matters is made initially with the designated person in the relevant business unit. If further guidance is required, matters may be referred to the Ethics Partner or other personnel in the Quality and Risk Management department.

We reviewed the firm's ethical policies and procedures and considered them to be comprehensive.

2.3.2 *Compliance monitoring procedures*

Annual declaration of compliance

Ernst & Young carries out an annual exercise at the end of each financial year in which partners and staff confirm their personal and financial independence of the firm's audit clients. The process is electronic and managed by the Quality and Risk Management department and business unit leaders follow up outstanding confirmations.

We reviewed the firm's procedures for monitoring the completion of the confirmations for the year ended 30 June 2007 and noted that by 30 September 2007 confirmations had been received from all partners. No breaches of the firm's ethical policies were identified.

In 2006 the firm adopted a database developed by EYG for recording business relationships. Under the firm's policies, all joint ventures, alliances, co-operative business relationships and material purchases or sales involving audit clients are to be recorded in the database and require approval before being entered into.

Non-audit services

Ethical Standards require audit engagement partners to demonstrate that proper consideration is given to the possible threats to the firm's independence and objectivity arising from the provision of non-audit services and to ensure appropriate safeguards are put in place. We considered the application of these requirements in all the individual audits we reviewed and noted that, in the large majority of cases, these requirements had been applied. However, we considered there was insufficient evidence on file for one of the audits we reviewed to demonstrate that proper consideration had been given to the possible threats to the firm's independence and objectivity arising from a tax audit partner who also provided tax advice to his audit client.

2.3.3 *Rotation policies and monitoring*

Firms are required to have policies and procedures in place to monitor the length of service of partners and senior staff on individual audit engagements, assess any threats arising to auditor objectivity and implement appropriate safeguards. This reflects the need to avoid auditor independence being compromised by the familiarity threat arising from a long period of service in a senior role. For listed company audits, the engagement partner and engagement quality control reviewer are required to rotate after having served for a maximum period of five years and key audit partners are required to rotate after seven years.¹⁰

Rotation policies and guidance

During the year, the firm updated its comprehensive policy document on the rotation of audit partners and other senior professional staff. It also updated its application guidance on the identification of key audit partners involved in the audit of large public interest entities.

¹⁰ APB Ethical Standard 3, paragraphs 5, 6, 12 and 16. "Key audit partners" are partners other than the audit engagement partner responsible for key audit decisions or judgments.

Rotation monitoring

In 2005 the firm introduced a database for the recording and effective monitoring of partner rotation. The database may be accessed by all levels of professional staff and contains details of the audit partner, engagement quality control review partner, key audit partners and other partners and staff in senior positions for each audit engagement.

We reviewed the firm's FTSE 100 audit clients to ascertain how many key audit partners were identified in respect of them. At the time of our review, there were some FTSE 100 audit clients for which the identified key audit partners had not been recorded in the database.

Subject to the comment above, we considered the firm to have effective rotation policies and procedures.

2.4 Audit performance

This section covers findings arising from our review of the firm's audit methodology and our review of individual audits. Our findings are set out under the following headings:

- 2.4.1 Audit methodology
- 2.4.2 Assessing and responding to risk
- 2.4.3 Audit evidence and related judgments
- 2.4.4 Communicating with Audit Committees
- 2.4.5 Audit finalisation

Any findings relating to quality control and independence are covered in Sections 2.2 and 2.3 respectively.

2.4.1 *Audit methodology*

Ernst & Young's audit methodology was developed by EYG on a world-wide basis for use by member firms and is based on the requirements of the International Standards on Auditing. The firm's technical department develops the additional material required to address UK specific requirements.

During the year the firm introduced its new audit support system for the audit of financial statements for periods ending on or after 31 December 2007 for all but the smallest audit engagements. The new system takes advantage of significant technological developments and aims to assist engagement teams in audit planning and improving audit quality. The

system is essentially electronic with significant amounts of evidential and supporting material being retained in hard copy form. Audit partners and staff have had extensive training on the new system which is fully integrated with the firm's audit methodology, which has been restructured to align it to the work flow of an audit using the new system. Apart from this, there were no other changes of significance to the firm's audit methodology during the year. The individual audit engagements we reviewed during this inspection related to periods prior to the introduction of the new audit support system.

In our view, Ernst & Young's audit methodology addresses the requirements of auditing standards in the UK in all material respects. However, a number of specific application issues arose as outlined below.

2.4.2 Assessing and responding to risk

Identification of significant risks

Auditing Standards require the identification and assessment of the risks of the financial statements being materially misstated, including which of these risks require special audit consideration (such risks are termed "significant risks")¹¹. A proper assessment of the significance of identified risks is important to ensure that audit work planned and undertaken is sufficiently focused on higher risk areas of the audit.

The firm's audit methodology provides guidance on the identification of significant risks and on the scope of work to be performed concerning the evaluation of the design and implementation of the related controls. In half the audits we reviewed, we identified areas for improvement particularly concerning the identification of significant risks or the evidencing of the evaluation of the design and implementation of the related controls.

Analytical procedures

Auditing Standards require the auditor to apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment. Where analytical procedures are performed to obtain audit evidence and as risk assessment procedures, independent expectations of the results of such procedures should be set in advance, and variances from expected values should be investigated and management explanations corroborated. In half the audits we reviewed, we considered there was room for improvement in the application and performance of these procedures.

¹¹ International Standard on Auditing (UK and Ireland) 315, paragraphs 100 and 108

2.4.3 Audit evidence and related judgments

We reviewed a number of significant audit judgments, including such matters as the rationale for accounting treatments, the reasonableness of assumptions in valuations and estimates and the judgments concerning the extent of audit work performed. Following discussion with the relevant audit teams, we were generally satisfied that the rationale for the significant judgments had been given proper consideration. However, there were certain areas in a number of audits we reviewed in which we identified issues as noted below.

The audit of revenue

In one audit, due to the dearth of evidence on file of the firm's planned approach or how the work performed contributed to the audit of revenue, it was unclear to us on what basis the audit team had concluded that sufficient appropriate audit evidence had been obtained in this area.

Tax disclosures

In another audit, there was, in our view, insufficient evidence on file to support an audit judgment relating to the disclosure of certain tax matters in the entity's financial statements.

Use of memoranda as audit evidence

In another audit, there was, in our view, insufficient evidence on file to support the judgments concerning an impairment review. The file included an internal memorandum that set out the procedures the firm had undertaken but, in our view, it was descriptive and not evidential in nature.

Using the work of an expert

Auditing Standards require that when planning to rely on the work of an expert, the auditor should evaluate the professional competence and objectivity of the expert. We reviewed the application of these requirements in all the audits we reviewed and noted that, in the large majority of cases, these requirements were applied. However, in a small minority of audits we reviewed, there was room for improvement in the evaluation of the professional competence and objectivity of experts on whom the firm relied.

2.4.4 *Communicating with Audit Committees*

Auditing Standards require the auditor to communicate matters of governance interest arising from the audit with those charged with governance of the entity. Such communications will usually take place with an Audit Committee or similar body acting on behalf of the Board¹². Appropriate communication with the Audit Committee or other relevant governance body contributes to the quality of the audit and assists both parties to discharge their responsibilities effectively.

We considered the firm's communications with Audit Committees for all the individual audit engagements we reviewed. In our view, they were generally of a good standard, focused on the key issues and presented in a balanced and informative manner. However, in a small minority of the audits we reviewed, we noted inconsistencies between what was communicated to those charged with governance and the execution of the audit engagement itself. In one case, we noted that uncorrected misstatements affecting earnings in excess of the 'clearly trivial' threshold had not been reported to an Audit Committee.

In another case, it was not clear on what basis a balance sheet reclassification was not reported to an Audit Committee. After discussion with the firm, we concluded that the firm's guidance on how to determine whether balance sheet reclassifications should be reported to Audit Committees needed clarification to comply fully with Auditing Standards.

2.4.5 *Audit finalisation*

Audit finalisation procedures include a final analytical review of the financial statements as a whole, a review of events occurring after the end of the financial year that may require adjustment of, or disclosure in, the financial statements ("subsequent events") and consideration of the appropriateness of the going concern assumption in preparing the financial statements.

We reviewed the firm's audit finalisation procedures for all the individual audits we reviewed and considered they were generally performed to a good standard. However, in half the audits we reviewed, there was room for improvement either in the application or in the evidencing of the firm's procedures in relation to one or more of the following areas: final analytical review, going concern, the dating of audit reports or the archiving of completed audit files.

8 December 2008

END OF REPORT

¹² International Standard on Auditing (UK and Ireland) 260, paragraph 11

Appendix A – Firm’s response

The firm’s response is on the following page.

**Response to Public Report
on the 2007/8 Inspection of
Ernst & Young LLP**

Ernst & Young supports fully independent regulation and thanks the Professional Oversight Board for this opportunity to comment on this first public report on our UK firm.

The selection of standards for determining what matters fall to be reported publicly is a complex task. It is our hope that these standards will develop over time so that they are based on observable criteria with the objective that all stakeholders can have shared expectations for the content of public reports.

We shall continue to work closely with the Audit Inspection Unit to understand their expectations of us, the nature of the inspection findings, and the attendant implications for audit quality, so as to make appropriate changes to our procedures. We also wish to register our thanks for the Unit's guidance during the course of their work.

Ernst & Young
London
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