



AUDIT INSPECTION UNIT

PUBLIC REPORT ON THE 2010/11 INSPECTION OF ERNST & YOUNG LLP

26 JULY 2011

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 on behalf of the Oversight Board.

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1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the inspection of Ernst & Young LLP (“EY” 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”), for the year to 31 March 2011 (“the 2010/11 inspection”). Our inspection was conducted in the period from April 2010 to February 2011 (referred to as “the time of our inspection”). The objectives of our work are set out in Appendix A.

Our inspection consisted of reviews of individual audit engagements and a review of the firm’s policies and procedures supporting audit quality.

We reviewed 13 audits undertaken by the firm in our 2010/11 inspection. These related to FTSE 100, FTSE 250, other listed and major public interest entities with financial year ends between June 2009 and May 2010. Our reviews were selected on a risk basis, using a risk model, and covered only selected aspects of the audits.

Each year we select a number of areas of particular focus. For 2010/11, these were: the fair value measurement of assets and liabilities, the impairment of assets (including goodwill and other intangible assets), revenue recognition and fraud risks, segmental reporting and the evaluation of going concern. Certain of our reviews were restricted to some or all of these areas.

In addition, we undertook a follow up review to assess the extent to which our prior year findings on that audit had been addressed in the following year’s audit.

Our review of the firm’s policies and procedures supporting audit quality covered the following areas:

- Tone at the top and internal communications
- Transparency report
- Independence and ethics
- Performance evaluation and other human resource matters
- Audit methodology, training and guidance
- Client risk assessment and acceptance/continuance
- Consultation and review
- Audit quality monitoring
- Other firm-wide matters

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, 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. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

Further information on the scope of our work and the basis on which we report is set out in Appendix A.

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 during our next inspection.

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

The AIU acknowledges the co-operation and assistance received from the partners and staff of EY in the conduct of the 2010/11 inspection.

1.2. Background information on the firm

Ernst & Young LLP is a UK limited liability partnership and the UK member firm of the EY global network of firms and EY Europe. EY Europe controls Ernst & Young LLP and the UK partners are also members of EY Europe. EY is managed by a UK Board appointed by the Europe Executive and the UK Country Managing Partner who has full authority to deal with the firm's general and operational management.

The firm operates through four service lines: Assurance, Advisory, Tax and Transaction Advisory Services. The UK Assurance practice has two principal business units, 'Financial Services' and 'UK & Ireland' ('UK&I').

For the year ended 30 June 2010, the firm's turnover was £1,356 million, of which £403 million related to the Assurance line of service ("Assurance"). There were 534 partners, of whom 117 were authorised to sign audit reports. There were also 71 employees (audit directors) who were authorised to sign audit reports¹.

¹ As disclosed in the annual return to the ICAEW as at 31 May 2010.

The AIU estimates that the firm had 295 audit clients within the scope of independent inspection by the AIU as at the 2010/11 reference date of 26 February 2010. Of these audit clients, AIU records show that 133 had securities listed on the main market of the London Stock Exchange, including 15 FTSE 100 audit clients and 35 FTSE 250 audit clients.

1.3. Overview

We focus in this report on matters where we believe improvements are required to safeguard and enhance audit quality. We set out our key messages to the firm in this regard in section 1.4. While this report is not intended to provide a balanced scorecard, we highlight certain matters which we believe contribute to audit quality, including the actions taken by the firm to address findings arising from our prior year inspection.

The firm places considerable emphasis on its overall systems of quality control and, in our view, has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas which are subject to our review. Nevertheless, we have identified certain areas where improvements are required to those procedures, which are set out in this report.

Our principal findings, as set out in section 2, largely relate to the application, rather than the design, of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits.

1.4. Key messages

The firm should pay particular attention to the following areas in order to enhance audit quality:

- Ensure that audit teams' assessments of the reasonableness of the growth rates and other assumptions, source data and methodologies used by management in assessing the potential for impairment of goodwill and other assets are supported sufficiently with appropriate audit evidence. Audit teams need to demonstrate appropriate scepticism in assessing growth rates which appear to exceed historical trends and the impact of changes in the client's market.
- Ensure that the content and timing of group audit instructions issued to component auditors are appropriate and that the audit files evidence how the group auditors have assessed the adequacy of work performed by them.

- Ensure that sufficient professional scepticism is exercised by audit teams in connection with the identification of related parties and the audit of related party transactions.
- Implement improvements in the quality and effectiveness of finalisation procedures.
- Consider how the annual partner and staff appraisal process can be enhanced to ensure that an individual's performance in relation to audit quality, including the findings of relevant internal and external quality reviews, is specifically assessed in all cases.

2 Principal findings

The comments below are based on our reviews of individual audits and the firm's policies and procedures.

2.1 Review of audit engagements

Follow up of audits reviewed in the prior year

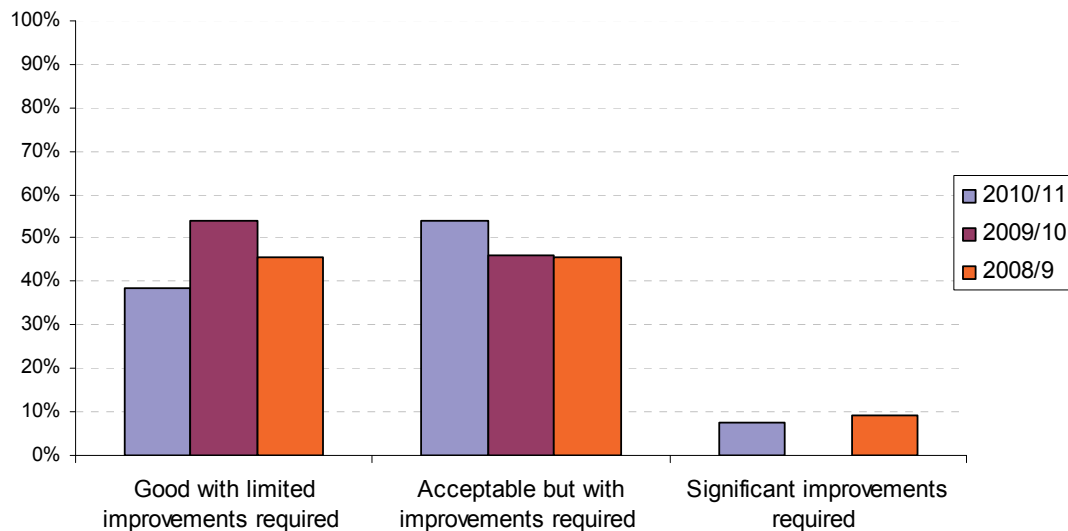
We undertook one follow-up review of an audit reviewed by us in the prior year. The issues we raised had been satisfactorily addressed, resulting in improvements to audit quality in the relevant areas.

Audits reviewed in the current year

We reviewed selected aspects of 13 audits (2009/10:13). Five (2009/10: seven) of the audits were performed to a good standard with limited improvements required; seven (2009/10: six) audits were performed to an acceptable standard but with improvements required; and one (2009/10: none) audit required significant improvement in relation to the assessment of the impairment of goodwill.

An audit is assessed as requiring significant improvement if the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of audit judgments in one or more key audit areas or the implications of concerns relating to other areas are considered to be individually or collectively significant. This assessment does not necessarily imply that an inappropriate audit opinion was issued.

The bar chart below shows the percentage of the audits we reviewed in 2010/11 by AIU grade together with comparatives for 2009/10 and 2008/9.



Due to the size of the samples involved, changes in performance from one year to the next are not necessarily indicative of an overall change in audit quality.

Findings in relation to audit evidence and judgments

The focus of our reviews has been on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk. We reviewed a number of key audit judgments, paying particular attention to impairment of goodwill and other intangibles, the valuation of assets held at fair value, revenue recognition and fraud risks, segmental reporting and the going concern assessment.

We draw attention to the following findings which the firm should ensure are adequately addressed in future audits:

- Impairment of goodwill and other assets
On four audits, the files did not contain sufficient audit evidence of audit teams having either assessed the reasonableness of the growth rates or other assumptions used or reviewed source data and methodologies used by management in their projections to assess the potential for impairment of goodwill.

On two audits, there was insufficient evidence of the audit team's consideration of intangible assets including those deemed to have indefinite lives.

- Impairment of loans and advances
On one audit of a financial institution, there was insufficient evidence that the audit team had challenged key assumptions and judgments made by management in

determining whether specific impairment provisions were required for two out of a sample of 40 loans and advances to customers reviewed.

- Group audits

On four of the audits we reviewed, we identified weaknesses in either the content or timing of the referral instructions issued to component auditors, or in the information received from the overseas component audit teams and how this was addressed on the group audit files.

On one of these audits (of a financial institution), much of the audit work was performed by overseas EY network firms on a product groupings (“business lines”) basis, rather than by individual entity. It was, therefore, not possible to determine from the UK audit files whether sufficient substantive evidence had been obtained to support material balances and disclosures in the financial statements of the UK entity. All of the risks involved in a large proportion of the transactions of the entity were transferred to the overseas parent company through detailed guarantees, and transactions for which the risks were not transferred were audited substantively by the UK audit team.

On one group audit there was insufficient evidence to show how the group auditors assessed the adequacy of the work performed by the component auditors for group audit purposes. The group audit partner did not visit the main overseas location, although we believe that it would have been appropriate to do so and we understand that this would have been required under the firm’s methodology.

- Revenue recognition and fraud risks

In two of the audits we reviewed there was insufficient evidence to support the contract revenue recognised in the current year. In one of these cases there appeared to be no explicit testing undertaken to confirm the accuracy of the underlying data used by management to calculate revenue recognised on long term contracts or to challenge management's explanations in relation to certain accounting judgments.

- Segmental reporting

IFRS 8, ‘Operating Segments’, became effective from 1 January 2009. The standard specifies how an entity should report information about business components whose results are regularly reviewed by management to make decisions about operating matters. Judgements are often required in the identification of these components.

In three of the audits we reviewed, there was insufficient evidence of the audit team’s consideration of the application of IFRS 8 to the identification of operating segments.

- Related parties
IAS 24, 'Related Party Disclosures', requires the existence of related parties and transactions with such parties to be disclosed in the financial statements. In four audits, we identified deficiencies relating to the audit of related party disclosures and transactions.

Recurring findings from one year to the next

Areas where there has been no improvement compared with last year

At the time of the relevant audits, the firm did not appear to have taken effective action to address the recurring findings related to goodwill impairment assessments and the audit of revenue (as detailed above) or the matters detailed below under audit finalisation. These matters continue to require improvement and we expect the firm to deal with them effectively.

Areas with an improvement compared with last year

While we have seen some improvement in relation to the following matters, reflecting a number of positive steps by the firm, continued effort is required to achieve further improvements:

- Communicating with the Audit Committee
On five audits we reviewed, we found that independence threats and identified safeguards adopted, particularly in regard to the provision of non-audit services, were not adequately reported to audit committees. In addition, on four audits we reviewed, we identified other weaknesses in communication, including significant audit findings not having been adequately reported or, in some cases, evidenced as having been reported.
- External confirmations
Auditing Standards state that audit evidence is more reliable when it is obtained from independent sources external to the entity. In one of the audits we reviewed, insufficient audit work in relation to the confirmation of material balances was performed or evidenced. Whilst we had fewer findings than last year, the firm should maintain its efforts to obtain direct confirmations where possible.
- Use of experts
The use of internal and external experts was generally evidenced satisfactorily and contributed to the quality of audits when they were integrated into the audit process.

However, on three audits we reviewed there was insufficient evidence of either consideration of the use of experts or of the assessment of the competence, experience and objectivity of third party experts when they were used.

- Substantive analytical review

We have reported in previous years that there was a need for improvement in the performance of analytical procedures to obtain substantive audit evidence. In two of the audits we reviewed this year the differences between the recorded amounts and expectations were calculated using prior year figures as the expectations. This did not provide sufficient substantive evidence for certain categories of cost on these two audits. Whilst the number of findings has again reduced in the current year, the firm needs to continue to focus on achieving improvements in this area.

- Significant risks

We identified continuing problems relating to insufficient linkage within the working papers to the evaluation of the design and implementation of controls over significant risks (5 audits) and no detailed evidence of fraud risk discussions (2 audits). The firm has, however, continued to place emphasis on this area in audit training and we found some further improvement this year.

Other findings in the current year

- Signing and dating of audit reports

On two audits the auditor's report was signed prior to the completion or evidencing of all necessary review procedures.

- Completion of audit disclosure checklists

The firm's policy is that audit teams must complete a financial statement disclosure checklist as part of their audit procedures on the financial statements. Audit teams are permitted to use a checklist completed by the client, if available, as the starting point for audit procedures, but in such cases teams are still required to re-perform the checking process. On two of the files that we reviewed it was unclear from the audit file whether the team had re-performed the completion of the financial statements disclosure checklist.

- Audit finalisation

We found weaknesses in connection with audit finalisation procedures on seven of the audits we reviewed. The majority of these weaknesses related to undetected clerical drafting errors in the accounts including, in one case, an error in the disclosed

audit fee. We believe that these errors should have been identified by more rigorous review procedures.

2.2 Review of the firm's policies and procedures

The firm generally has appropriate policies and procedures in place for its size and the nature of its client base in those areas which are subject to our review. The policies and procedures are largely developed globally and the UK firm puts significant resources into its central support functions, such as HR, risk management, audit and accounting technical and independence compliance.

We identified certain areas for improvement in the firm's procedures or their application in practice, as outlined below, which need to be addressed.

Progress on dealing with prior year findings

The firm has generally made good progress in acting on our findings from last year, and there have been a number of improvements to the firm's procedures. In particular, the firm has increased the number of internal audit quality reviews ('AQR'), removed the pre-printed section specifying target percentages for the off-shoring of audit work from annual appraisal documentation and put effort into ensuring that all staff appraisal documentation is completed on a timely basis in accordance with firm's policies. The only prior year finding which had not been fully implemented during the year is as follows:

- Annual partner appraisals

Whilst partner appraisal forms were generally completed satisfactorily, we noted one case where the annual development plan had not been completed on a timely basis and two cases where scores had not been completed for the four individual areas, including 'quality', within the balanced scorecard although the partner's overall rating was completed in both these cases.

We also noted one case where a partner had taken credit within his annual appraisal documentation for "account relationship development progressing strongly with increased tax and Transaction Advisory Services participation on three audit clients". Whilst the partner concerned did not quantify the value of any non-audit services involved, in our view the wording used implies that credit is being sought for the potential sale of non-audit services contrary to the underlying principles of the Ethical Standards and the firm's policy in this area.

Other findings in the current year

Focus on growth and efficiency

The firm continues to include emphasis on growth and efficiency in its strategy and related communications. The firm's leadership should ensure that it maintains its focus on achieving improvements in audit quality, even though it has established a specific programme to reduce audit costs.

Audit quality monitoring

On one of the group audits we reviewed, which was also the subject of an AQR review, we identified that the AQR questionnaire did not include specific procedures to consider whether the work of component auditors was adequately reviewed in particular cases where substantially all of the audit procedures were performed by them.

The firm aims to perform an AQR review on each FTSE 350 client at least once every six years. However, we noted that two FTSE 350 clients had not been reviewed in the last six years, including one FTSE 100 client. In our view, the firm should ensure that it meets its target of covering each FTSE 350 client at least once every six years or documents the reasons and approval for any extensions granted.

Reflecting the results of AIU and AQR reviews in annual appraisals

We found that internal and external quality review findings are not currently reflected in a consistent manner in the annual performance review documentation prepared to support the evaluation of an individual's performance.

Updating of rotation database

The rotation database had not been properly updated for two FTSE 350 clients. In one case, the key partner responsible for an overseas subsidiary was not included in the database. In the other, two of the overseas key partners and three specialists designated as key partners were not included on the database. Although the papers which formed the basis for the firm's conclusions with respect to rotation for both clients included the relevant details and considerations, in our view it is important that this key independence database is maintained accurately.

Client continuance assessments

We found two instances where there was no evidence of formal approval of client continuance for FTSE 100 clients until a few days before their respective audit reports were signed. We were informed that continuance risk was considered by the audit teams during the audit process in both cases.

Resolution of compliance issues

The firm's core annual independence and ethics compliance process was completed in May 2010. However, a number of the exceptions assessed by the firm as low risk were not formally planned to be resolved by the firm's compliance team until after December 2010. The firm assessed whether exceptions raised by individuals were likely to result in a breach and follow up was prioritised accordingly. In our view, this timetable should be accelerated in future.

Reporting of contingent fees to the Audit Committee

Ethical Standards require contingent fee arrangements to be reported in writing to the Audit Committee of a listed audit client. We noted one case in which a tax service was provided to an audit client on the basis that a proportion of the time-based fee would be reimbursed in specific circumstances. After consulting internally, the audit team assessed this time-based fee arrangement to be a "differential fee", rather than a contingent fee as defined in the extant Ethical Standard. Although the project was referred to by name in reporting to the Audit Committee, the basis of the fee arrangement was not reported. In our view, the level of the fee was, in substance, directly contingent on whether a specific outcome was achieved and the fee arrangement should therefore have been made clear to the Audit Committee.

Andrew Jones
AIU Director
26 July 2011

Appendix A – Objectives, scope and basis of reporting

Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. 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.

Our reviews of individual audit engagements and the firm's policies and procedures cover, but are not restricted to, the firm's compliance with the requirements of relevant standards and other aspects of the regulatory framework. Our reviews of individual audit engagements place emphasis on the appropriateness of key audit judgments made in reaching the audit opinion together with the sufficiency and appropriateness of the audit evidence obtained.

We seek to identify areas where improvements are, in our view, needed in order to safeguard audit quality and/or comply with regulatory requirements and to agree an action plan with the firm designed to achieve these improvements. Accordingly, our reports place greater emphasis on weaknesses identified requiring action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool. We also assess the extent to which the firm has addressed the findings arising from its last AIU inspection.

Our inspection was not designed 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.

The monitoring units of the professional accountancy bodies in the UK which 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 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.

Basis of reporting

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 which the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including EY annually. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's 2010/11 report to the ARC, which was finalised in May 2011, recommended that the firm's registration to conduct audit work should be continued.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, 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. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising on one or more audits. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

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. 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 may therefore apply equally 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 are selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

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 may be 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 AIU also issues confidential reports on the individual audits reviewed by it during an inspection. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide copies of the reports to the directors of the relevant clients.

Purpose of this report

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.

Appendix B – Firm’s response

The firm’s response is on the following page.

Audit Inspection Unit
Aldwych House
71-91 Aldwych
London
WC2B 4HN

4 July 2011

Dear Sirs

AIU Public Report on the 2010/11 Inspection of Ernst & Young LLP

We welcome the opportunity to respond to the AIU's report.

We are pleased that the report recognises our emphasis on audit quality. The quality of audit has never been more important than in the current environment and we recognise that independent audit inspection by the AIU plays a key role in assuring audit quality in the UK.

We will continue to work constructively with the AIU to meet our common aim.

We would like to record our appreciation of the open way in which your staff conducted this year's review.

Yours faithfully

Ernst & Young LLP



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