



Financial Reporting Council

ERNST & YOUNG LLP

AUDIT QUALITY INSPECTION

JUNE 2018

The FRC

Our mission is to promote transparency and integrity in business.

transparency



We have responsibility for the public oversight of statutory auditors.

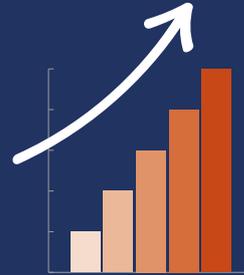
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



AQR

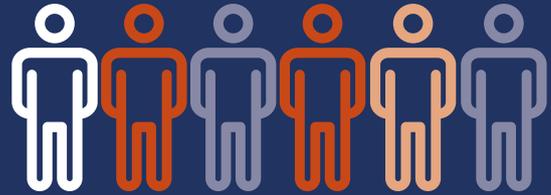
We monitor the quality of UK Public Interest Entity audits.

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+3.20	0.21%	+2.83%	-15.93%	NEG	-3.9993
+3.85	0.14%	+2.42%	-17.67%	POS	-4.2421
+3.38	0.27%	+2.19%	-18.32%	NEG	-4.2083
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+3.31	0.20%	+2.76%	-20.12%	NEG	-2.8339



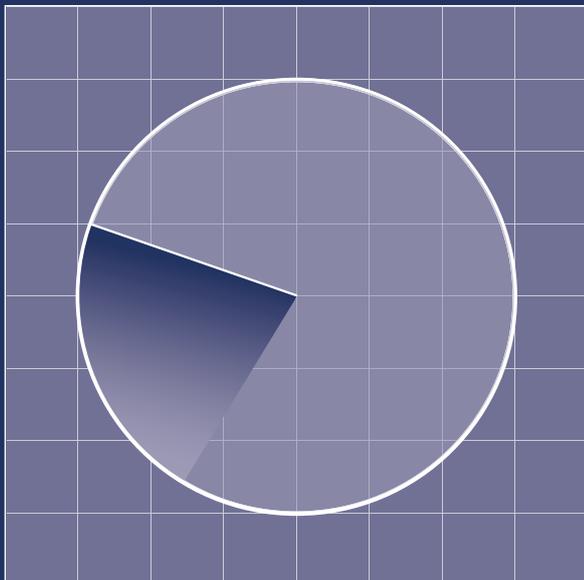
We promote continuous improvement in audit quality.

Our team of over 40 professional and support staff has extensive audit expertise to provide rigorous inspection of audit firms.



The Firm

EY has 347 audits within the scope of AQR inspection, including 14 FTSE 100 and 41 FTSE 250 audits.



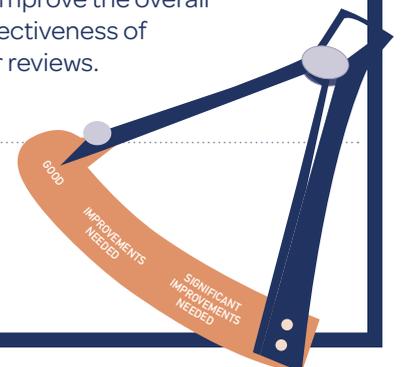
Our inspection process

There are around 2350 audits within the scope of AQR inspection. In total, we inspected 145 individual audits in 2017/18, including 18 at EY.



We work closely with audit committee chairs to improve the overall effectiveness of our reviews.

We assess the overall quality of the audit work inspected.



Financial Reporting Council

Ernst & Young LLP

Audit Quality Inspection

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AQR's objective is to monitor and promote improvements in the quality of auditing.

AQR assesses the quality of audit work and policies and procedures supporting audit quality at firms which audit Public Interest Entities.

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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1 Overview

This report sets out the principal findings arising from the 2017/18 inspection of Ernst & Young LLP (“EY” or “the firm”) carried out by the Audit Quality Review team (“AQR”) of the Financial Reporting Council (“the FRC”). We conducted this inspection in the period from March 2017 to February 2018 (“the time of our inspection”). We inspect EY, and report publicly on our findings, annually.

Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm’s audit work. Our findings cover matters arising from our reviews of both individual audits and the firm’s policies and procedures which support and promote audit quality, focusing on changes arising from the revised Auditing and Ethical Standards¹.

We plan to implement a new audit firm monitoring approach for the six largest firms from 2018/19². This approach focuses on five key pillars: leadership and governance, firm values and behaviours, business models and financial soundness, risk management, and evidence of audit quality.

We are grateful for the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2017/18 inspection.

Our assessment of the firm’s performance

The overall results of our reviews of the firm’s audits show that 67% were assessed as requiring no more than limited improvements, compared with 88% in 2016/17. This is a disappointing outcome in comparison to the progress made in the previous two years. Of the FTSE 350 audits we reviewed this year, we assessed 82% as achieving this standard compared with 92% in 2016/17. The FRC’s target is that at least 90% of these audits should meet this standard by 2018/19.

Where we identified concerns in our inspections, they related principally to the audit of aspects of provisions in financial services entities and the audit of pension scheme assets and liabilities. During the year, the firm has continued to implement its Audit Quality Programme, including a focus on audit team behaviours, the firm’s Audit Quality Support Team, coaching and project management. We have seen improvements in all areas where we had key findings last year, in particular the audit of revenue, including the use of revenue data analytics, and communications to audit committees.

The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement.

1 The firm was also included within the scope of our thematic review on Audit Firm Culture. The report, published in May 2018, sets out how audit firms are seeking to embed a culture which supports high quality audit: [Audit Culture Thematic Review](#)
2 [AFMA Press Notice](#)

Key findings in the current year requiring action

Our key findings in the current year requiring action by the firm are set out below. Further details are given in section 2, together with the firm's actions to address them.

Individual audit reviews

The firm should:

- Increase the extent of challenge and assessment of management's key assumptions and inputs in relation to conduct provisions in financial services entities.
- Strengthen the audit of collective loan loss provisions in financial services entities.
- Improve the audit of company pension scheme assets.
- Enhance the reports from the firm's internal actuarial experts on company pension scheme liabilities.

Firm-wide procedures

The firm should:

- Amend its policy and guidance on hospitality in relation to allowable thresholds.
- Implement monitoring of what is a permissible non-audit tax service.

Assessment of the quality of audits reviewed

The bar charts below show the results of our assessment of the quality of the audits we reviewed in 2017/18, with comparatives for our four previous inspections³. The number of audits within each category in each year is shown at the top of each bar.

The first chart shows the results for all audits reviewed. The second chart shows the results for FTSE 350 reviews only.

³ Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews. For this reason, and given the sample sizes involved, changes from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Chart 1: All reviews

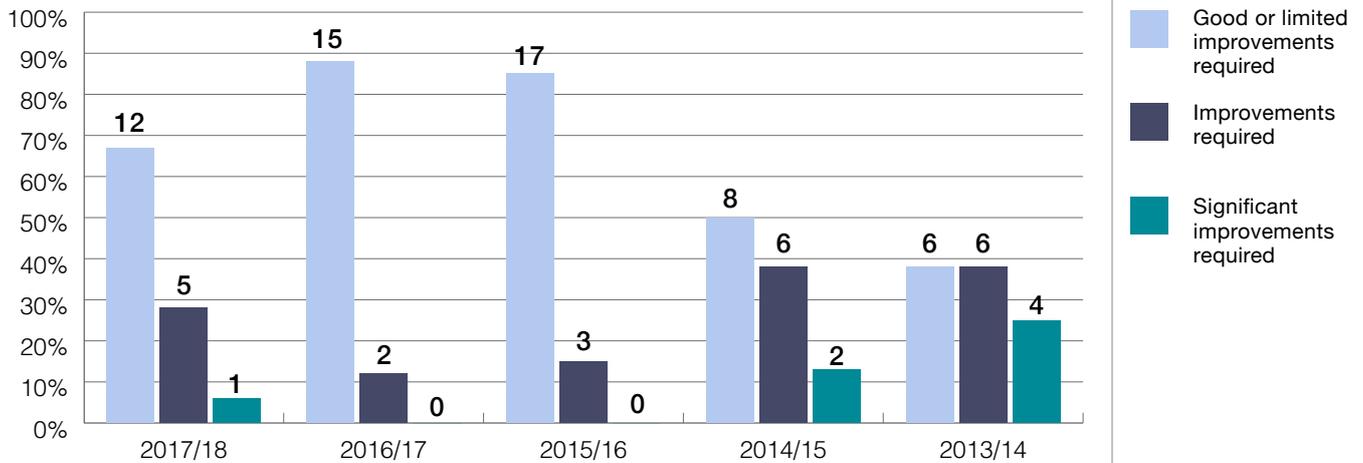
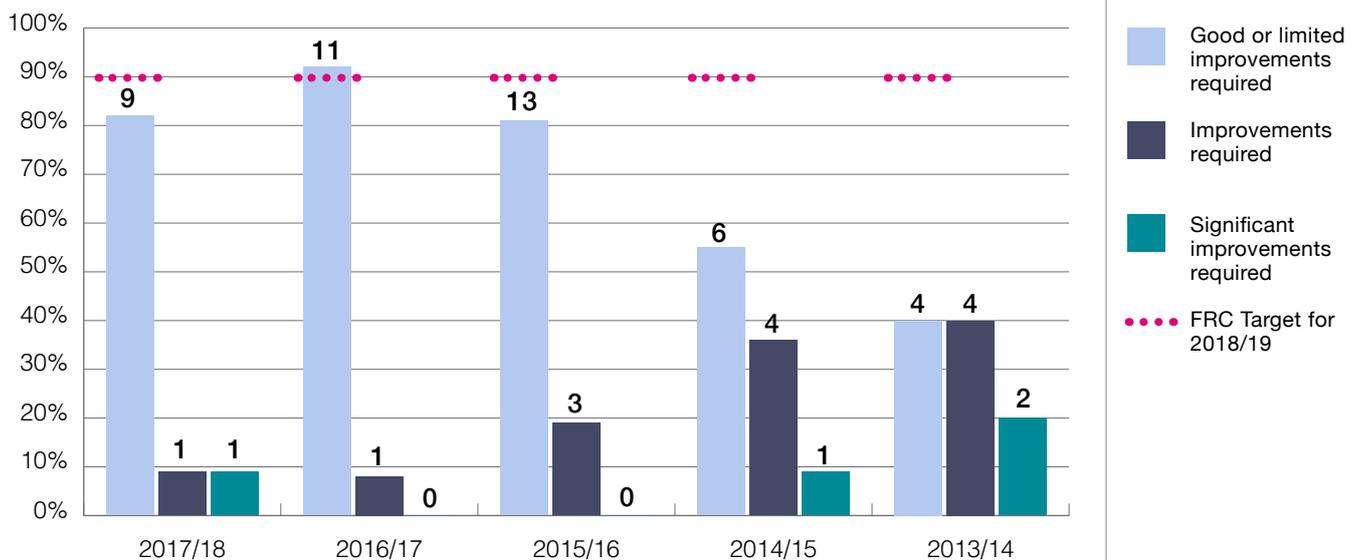


Chart 2: FTSE 350



Good practice identified

Examples of good practice we identified in the course of our work include the following:

Individual audit reviews

- Group audit teams’ oversight of, and involvement with, component auditors.
- Use of, and co-ordination with, specialists and experts.
- Clear explanations of the audit judgements and conclusions in areas of significant risk.

Firm-wide procedures

- Certain independence procedures and the response to the revised Ethical Standard requirements, including the involvement of the independence team in accepting or continuing an audit and the monitoring of non-audit services provided to audited entities.

Further details and examples are set out in section 3.

Root cause analysis

Thorough and robust root cause analysis (“RCA”) is necessary to enable firms to develop effective action plans which are likely to result in improvements in audit quality being achieved.

Our report on Audit Firm Culture stated that, based on RCA undertaken through 2017, all firms covered by that review had improved their RCA since our 2016 thematic review. We also reported that firms should seek to develop their RCA techniques “to identify the behavioural or cultural factors that contributed to either good or poor quality outcomes”. The firm has performed RCA in respect of our key findings and considered the outcome in developing the actions included in this report. We will continue to assess the firm’s RCA process and encourage all firms to develop their RCA techniques further.

Firm’s overall response and actions:

We take seriously our role in helping to sustain stable capital markets, and executing high quality audits continues to be the priority for us. It is fundamental to our business and our public service obligations. We are therefore committed to significant and sustained investment in audit quality, and we welcome the insights provided by the FRC’s inspection.

Our Audit Quality Board continues to oversee matters relating to audit quality and sets the agenda for our Audit Quality programme, which has been a significant investment for us since it was set up in 2014.

We believe this investment has led to:

- An increase in the number of audits for which no findings were reported;
- The positive findings on complex and large group audits, some of which were first year audits; and
- The FRC’s conclusion that it identified improvements in all areas where it had findings last year.

Given these successes, we were very disappointed with the increase in audits assessed by the FRC as requiring more than limited improvements in the current year and particularly that for the first time in three years we have had an audit graded as requiring significant improvements. These results mean that although we achieved the benchmark of over 90% of our FTSE 350 audits being graded as requiring no more than limited improvements in the prior year, we have not achieved that this year. We are firmly committed to achieving and exceeding the FRC’s objective set for 2019 and will continue our focus on audit quality to achieve this.

Two of the four key findings from the FRC’s inspection relate to aspects of the audit of banks. The audit of banks is an area on which we have been engaging with the FRC, and in light of those discussions we undertook the actions as set out in our response in Section 2 of this report. We will continue this focus, and we will also share with our teams the instances of good practice highlighted by the FRC in relation to our work on loan loss impairment and conduct provisions, as set out in Section 3 of this report.

The other two key findings relate to the audit of pension balances. We took action to address these findings during the inspection.

Firm's overall response and actions:

Our root cause analysis of the FRC's findings as well as findings from our own internal quality control processes continues to be an important input into our Audit Quality programme. This analysis tells us that the factors key to our good quality results were the implementation of a new team coaching approach, a high degree of executive involvement, the support provided to audit teams by our Audit Quality Support Team (AQST) and more consistent use of new technology and enablers. In relation to the key findings highlighted by the FRC, the principal factors identified by our root cause analysis were insufficient engagement team focus on ensuring that audit work and the basis for the related conclusions were adequately explained, over reliance on the work of EY specialists supporting the engagement team, instances of insufficient application of professional scepticism and, in the case of pension scheme assets, insufficient focus on an area that was not a significant risk.

In our responses in Section 2 of this report, we have discussed the actions that we took during the period of the FRC's inspection in response to the key findings, together with the further actions we plan to take in light of our root cause analysis. In addition, we have detailed below some of our long term investment priorities for continuous improvement in audit quality which have been informed by the root cause analysis carried out over a number of years:

- Our audit team behavioural model, based on cognitive psychologists' research into exceptional audit quality, has been successful in improving audit quality. We will continue to increase the extent and consistency of the implementation of this valuable way of working. In particular we will encourage teams to replicate the success achieved when this way of working is used for individual audit risks including a focus on how the final body of audit evidence is accumulated, considered and presented.
- Our AQST team supporting certain audit teams will be increasing its resource, expanding its best practice sharing role and responding more proactively to higher risk areas.
- In addition to our focus on coaching, we are building the suite of tools and development activities to improve our project management skills in audit teams, and will be expanding the monitoring of audit project management by our central audit quality team.
- To help reinforce the behaviours of a high quality auditor, particularly in the areas of professional scepticism and the coordination with and reliance on specialists, we are integrating the Institute of Chartered Accountants in England and Wales' most recent training film, "Without Question", into our summer training programme.
- We will use our quality networks to focus on quicker sharing of best practices, particularly on loan loss impairment and conduct provisions on bank audits, as well as driving local initiatives focusing on technical updates, culture and behaviours.

We will continue to focus on these drivers of audit quality and we thank the FRC for its work and the independent perspective it brings.

2 Key findings requiring action and the firm's response

We set out below the key areas where we believe improvements are required to enhance audit quality and safeguard auditor independence. We asked the firm to provide a response setting out the actions it has taken or will be taking in each of these areas.

Increase the extent of challenge and assessment of management's key assumptions and inputs in relation to conduct provisions in financial services entities

The calculation of conduct provisions requires significant management judgement in estimating the exposures on matters such as PPI claims and customer redress. These estimates may be subject to conscious or unconscious management bias. Auditors need to demonstrate an appropriate level of challenge and professional scepticism when considering management's assumptions used in the estimation of these provisions.

Findings

We reviewed the audit of conduct provisions for three financial services entities. We identified insufficient evidence of challenge, assessment and corroboration of management's key assumptions in estimating conduct provisions, including the following on one or more audits:

- Insufficient evidence of challenge of management's assumptions on the potential impact of actions by third parties (for example, regulatory investigations);
- Lack of justification or challenge regarding the appropriateness of certain inputs and assumptions used to calculate provisions (for example, for claims rates);
- Insufficient audit procedures to assess the completeness and accuracy of key database information to estimate the conduct provision. There was also insufficient testing of whether the information used in the estimate had been correctly extracted from that database;
- Lack of evidence to support the audit team's conclusions (for example, details of management information and legal confirmations that had been reviewed).

Firm's actions:

The audit of banks is an area on which we have been engaging with the FRC, and in light of those discussions, we completed the following actions:

- We developed a detailed questionnaire covering a number of aspects of the audit of banks. Each bank audit team responded to the questionnaire setting out how they had addressed/planned to address these matters for 2017 year end audits. The individual responses were reviewed by the audit quality team, who identified differences in the scope of work assigned to our conduct specialists. The audit quality team discussed the responses with individual audit teams, challenging the approach where appropriate. For 2018 audits the audit quality team will work with audit teams to confirm the appropriate level of specialist involvement in auditing loan loss and conduct provisions depending on the circumstances for each audit.
- We shared the FRC's emerging findings with all audit partners, engagement quality control reviewers, technical and IT partners and associate partners involved in bank audits and discussed the background at our monthly Financial Services partner and associate partner call hosted by assurance leadership.
- We communicated key themes and messages to the wider Banking and Capital Markets audit practice via email in January 2018. In February 2018 our conduct specialists presented to the banking partners the key areas of focus in relation to conduct provisions.

In addition, the audit of conduct provisions is a focus area for reviews conducted and support provided by our AQST for 2017 and 2018 year end audits. Our audit quality leadership led a detailed briefing for the AQST reviewers on the matters raised by the FRC.

We will continue to focus on the audit of conduct provisions in our training programme for 2018.

We will also remind our bank audit teams that the audit workpapers must sufficiently evidence all of the key matters they considered. Not placing sufficient emphasis on this was one of the key areas identified by our root cause analysis.

Strengthen the audit of collective loan loss provisions in financial services entities

Loan loss provisioning is subjective and involves significant management judgement. Provisions for loans are calculated either on a specific basis, when individually impaired, or on a collective basis ('collective provisions'). The provisions are usually based on management models which include a number of assumptions. Audit teams need to perform sufficient procedures to corroborate and challenge the models' key inputs and assumptions to respond appropriately to the risks identified.

Findings

We reviewed the audit of loan loss provisions for three financial services entities and identified weakness in the testing of the loan impairment models and assumptions for collective provisions, including the following on one or more audits:

- There was insufficient testing and challenge of management’s assumptions relating to certain inputs to models.
- There was insufficient justification for the controls tested relating to the oversight of models and underlying assumptions.
- Where ineffective controls had been identified, audit teams did not demonstrate how these had either been mitigated through additional testing or shown not to have a material impact.

Firm’s actions:

We completed the actions referred to in our response to the finding on conduct provisions on page 10, which also applied to the audit of collective loan loss provisions, including the following:

- The audit quality team reviewed the bank audit teams’ responses to the questions around collective loan loss provisions in the questionnaire, following up with individual teams for clarifications or further explanations and challenging the approach where appropriate.
- We communicated key themes and messages relevant to loan loss provisions to our bank audit teams.

In addition, the audit of collective loan loss provisions is a focus area for reviews conducted and support provided by our AQST for 2017 and 2018 year end audits. Our audit quality leadership led a detailed briefing for the AQST reviewers on the matters raised by the FRC.

Our root cause analysis identified a need for improved integration of the work of specialists. We will provide training to our specialists and audit teams on this area.

We have provided extensive training on the changes in basis for determining collective loan loss provisions that IFRS 9 will require. We will continue to focus on this area in our training programme for 2018.

Improve the audit of company pension scheme assets

Defined benefit scheme assets are included on the balance sheet of companies at fair value, offset by pension liabilities, and can include investments which are hard to value. Auditors should focus sufficiently on testing the valuation of these investments to be able to identify any misstatement of pension assets that may be material to the company.

Findings

We informed all firms in December 2016 that the audit of pension balances and disclosures would be an FRC area of focus this year, and reviewed it in most audits at EY. The firm's audit approach to the valuation of pension assets was not always sufficient or appropriate, particularly for harder-to-value assets, for example:

- In relation to testing the valuations of certain pension assets, it was not appropriate to use sample sizes which were smaller than those required for other audit testing. At our request, the firm amended its guidance so that this approach is no longer permitted.
- Audit teams did not always test the valuation of pension scheme assets to sources which were independent of the entity.
- Audit teams did not always confirm valuations directly with external investment managers, and sometimes did not request or review reports over investment manager controls when placing reliance on the related controls for valuations of assets.

Firm's actions:

In response to emerging findings from the FRC's inspection we issued new guidance clarifying the requirements and considerations relevant to the audit of pension scheme assets, including examples to aid application of the guidance. The guidance included a revision to the approach to determining sample sizes. This was supported by training that was delivered as part of the mandatory autumn training programme. Our heightened focus has addressed the key root cause which was insufficient focus by teams on this area.

Our AQST reviewers were specifically briefed to review the audit of pension asset balances on the audits within that programme to ensure that the updated guidance is being applied.

We will continue our focus on this area through the review and coaching provided by our AQST and through our audit training in 2018.

Enhance the reports from the firm's internal actuarial experts on company pension scheme liabilities

Defined benefit pension scheme liabilities are included on company balance sheets, offsetting pension scheme assets. Their estimation often involves complex actuarial calculations supported by a number of significant assumptions. Auditors should understand the basis of the assumptions and methodologies used to support their assessment of whether the liabilities are appropriately valued. The firm's internal actuarial experts usually assist auditors, when concluding on the valuation of the liabilities, given the specialised nature of the calculations and assumptions.

Findings

The audit of pension balances and disclosures was an area of focus for our 2017/18 inspection work. We reviewed the audit work performed, drawing on the expertise of FRC actuaries in our review process. We generally found a good level of involvement from the firm's actuarial experts. However, the experts' reports (prepared for audit teams) did not always provide sufficient detail on how they had evaluated, challenged and concluded on certain aspects of the actuarial assumptions.

We identified examples of insufficient evidence or explanations from the actuarial experts for the following: appropriateness of management's assumptions; changes in management's key assumptions from one period to the next; and the basis on which the acceptable ranges for assumptions had been determined and why these were considered to be appropriate for that company's pension scheme.

We also identified cases where improvements were needed in clarifying the scope and extent of procedures performed by the firm's actuarial experts.

At our request, the firm has since enhanced the actuarial experts' standard reporting template and amended the related guidance issued to audit teams.

Firm's actions:

In response to emerging findings from the FRC's inspection we issued reminders to audit teams to ensure reporting from internal actuarial experts includes evidence of appropriate challenge of assumptions and changes in assumptions, explanations of the basis for the reasonable range of assumptions used and why they are appropriate for the specific scheme being considered and details of the specific checks and procedures performed by the actuarial team.

We held discussions with the leadership of the pensions actuarial team, agreeing more detailed requirements for their reporting and we developed an enhanced actuarial experts' standard reporting template which was available for use in audits of December 2017 year-end financial statements.

To supplement the enhanced reporting template described above, we will incorporate into our 2018 audit training detailed reminders on the responsibilities of the auditor when using the work of an expert to avoid the over reliance which was a theme identified in our root cause analysis.

We will also continue our focus on this area through the review and coaching provided by our AQST to ensure that the new detailed reporting is used and to ensure all relevant considerations are being recorded.

Amend the firm's policy and guidance on hospitality in relation to allowable thresholds and implement monitoring of what is a permissible non-audit tax service

A revised Ethical Standard ("ES") became effective during the year with enhanced requirements and stricter prohibitions. The firm therefore needed to ensure its policies and procedures complied with these requirements.

Given the importance of auditor independence and the impact of the revised ES, in March 2017 we reviewed the arrangements for independence and ethics at the six largest firms. This approach allowed us to benchmark arrangements across the firms and share good practice. Our review focussed on how the firm's policies and procedures address the revised ES requirements. We also reviewed compliance with the previous ES as part of our inspections of individual audits.

Findings

The firm has revised its policies and procedures in response to the revised Ethical and Auditing Standards. We have identified some examples of good practice, as well as certain areas for improvement.

We identified the following concerns:

- The firm's thresholds for permissible hospitality should be clarified and revised. The permitted levels of hospitality for audited entities did not, in our view, meet the new requirement to be 'trivial or inconsequential' from the perspective of an objective, reasonable and informed third party. We also had concerns with the firm's guidance in relation to permissible hospitality when provided or received 'for business purposes'. The firm's Board subsequently approved changes to its hospitality policy following our inspection.
- The firm does not centrally monitor the approval of the provision of non-audit tax services to PIEs which are permissible only if a specific exemption, based on criteria requiring significant judgement, applies.

Firm's actions:

Revised threshold levels for gifts and hospitality have been approved by the EY UK LLP Board. We will be amending our guidance in this area.

We will amend the firm's engagement acceptance process to enable the central independence team to monitor the permissibility of non-audit tax services for UK based EU PIE audit clients.

Other issues driving lower audit quality assessments

Other issues driving lower audit quality assessments on individual audits included the following:

- There were insufficient audit procedures and/or evidence for insurance and onerous contract provisions.
- Threats to auditor independence arising from the provision of certain actuarial non-audit services created a risk that a reasonable and informed third party would conclude that the auditor's independence was, or was likely to be, impaired.

3 Good practice examples and developments in the year

Good practice

We set out below the key areas where we noted good practice, either in audit work on individual engagements or firm-wide procedures.

Individual audit reviews

Group audit teams' oversight of and involvement with component auditors

For many of the group audits that we reviewed, we considered the group audit teams' direction and supervision of the component auditors' work to be of a high standard. We particularly noted this in more complex and larger groups, some of which were first year audits. On a number of reviews, the group audit teams kept a comprehensive log of issues raised by component audit teams, tracking how the group audit team resolved the issues.

Use of, and co-ordination with, specialists and experts

We identified examples of good practice where the firm's internal specialists and experts helped audit teams assess a wide range of management assumptions and judgements. This included good oversight and co-ordination of experts and specialists in areas such as goodwill and investments and involvement of industry experts going beyond what we normally see in these industries.

Clear explanations of the audit judgements and conclusions in areas of significant risk

Examples include a case where the audit team's review of certain aspects of individual loan loss provisions was extensive and captured how management had been challenged and how the audit team had applied professional scepticism.

In another case, where a consultation was required on a judgemental matter, the audit team clearly captured the chronology of events and matters that had been considered in forming their conclusions, including detailed notes of the consultation and the challenge of management.

Use of data analytics in the audit of revenue

The firm has provided further support and training to help audit teams use revenue data analytics more effectively. We saw examples of data analytic procedures performed on revenue to a good standard with informative reporting to the audit committee.

Firm-wide procedures

Ethics and independence procedures and the response to the revised ES requirements

- The firm requires all acceptance and continuance assessments for audits to be reviewed and approved by the central independence team, with specific independence approval procedures required for all listed and EU PIE audit clients prior to client acceptance.
- The firm's new acceptance and continuance system operates across all service lines and includes compliance requirements of the ES, IESBA Ethical Standards and the firm's network policies. This will help to prevent non-audit service requests where the service is potentially prohibited.
- The firm completed a comprehensive central review to assess all current non-audit services being provided to PIE audit clients ahead of the transition date. This included confirmation from audit engagement partners that prohibited services had been ended and that audit committee approval had been obtained for continuing non-audit services.

Developments in the year

Following actions from the firm, we have seen an improvement in relation to the key findings we highlighted in last year's report.

The firm has continued development of its Audit Quality Programme, including:

- Rolling out the findings of a project led by external psychologists to analyse the behaviours of audit teams;
- Continuing enhancement of its Audit Quality Support Team (AQST) performance of hot reviews of a sample of FTSE 350 and other major audits, providing direct feedback and coaching to audit teams and sharing their observations with the wider audit practice;
- Focusing on improving project management, aided by its audit systems to monitor key milestones on audits.

Audit Quality Review

FRC Audit and Actuarial Regulation Division

June 2018

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