Financial Reporting Council

May 2013

Ernst & Young LLP

Audit Quality Inspection

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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 Quality Review Team of the Financial Reporting Council ("the FRC"), during the year to 31 March 2013 ("the 2012/13 inspection"). We currently inspect EY annually. Our inspection was conducted in the period from April 2012 to February 2013 (referred to as "the time of our inspection"). The objectives of our work are set out in Appendix A.

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

We reviewed 12 audit engagements undertaken by the firm in our 2012/13 inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between December 2011 and April 2012. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit.

Our responsibility is to monitor and assess the quality of the audit work performed by the UK firm. Accordingly, our reviews of group audits covered the planning and control of the audit by the group engagement team, including their evaluation of the adequacy of the work performed by component auditors, and selected aspects of other work performed by the UK firm at group and/or component level.

Each year we select a number of audit areas of particular focus. For 2012/13 these were: the valuation of assets held at fair value; the impairment of goodwill and other intangible assets; the recoverability of deferred tax assets; the assessment of going concern; revenue recognition; and related party relationships and transactions.

In addition, we undertook two follow-up reviews to assess the extent to which our prior year findings on those audits 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

We exercise judgment in determining those findings which it is appropriate to include in our 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 our 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. 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, together with the firm's proposed action plan to address them, have been discussed with the firm. Appropriate action may have already been taken by the date of this report. The adequacy of the action 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.

We acknowledge the co-operation and assistance received from the partners and staff of EY in the conduct of this 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 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 Transactions Advisory Services. The UK Assurance practice has two principal business units, 'Financial Services' ("FSO") and 'UK & Ireland' ("UK&I"). It has 19 offices in the UK as well as offices in Jersey and Guernsey.

For the year ended 29 June 2012, the firm's turnover was £1,631 million, of which £478 million related to the Assurance service line. There were a total of 563 partners, of whom 110 were authorised to sign audit reports, and 65 employees (audit directors) who were authorised to sign audit reports[1].

We estimate that the firm audited 288 UK entities within the scope of independent inspection as at 29 February 2012. Of these entities, our records show that 125 had securities listed on the main market of the London Stock Exchange, including 13 FTSE 100 companies and 35 FTSE 250 companies.

[1] As disclosed in the annual return to the ICAEW as at May 2012.

Audits of entities incorporated in Jersey, Guernsey or the Isle of Man whose securities are traded on a regulated market in the European Economic Area are subject to inspection under arrangements agreed with the relevant regulatory bodies. Our records show that the firm has 43 such audits, including 2 FTSE 100 companies and 7 FTSE 250 companies.

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 most areas, has appropriate policies and procedures in place for its size and the nature of its client base. Nevertheless, we have identified certain areas where improvements are required to those policies and procedures. These are set out in this report.

Our file review findings, as set out in section 2, largely relate to the application of the firm's procedures by audit personnel, whose work and judgments ultimately determine the quality of individual audits. In particular, as in the prior year, an audit that required significant improvement was one where an exceptional proportion of partner and senior staff time was required to challenge appropriately certain judgments made by the entity's management. While additional support was provided to address these areas, the audit team was not sufficiently strengthened in other key audit areas to compensate.

1.4. Key messages

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

- Review existing procedures to ensure that additional resources are sought and made available in exceptionally challenging circumstances such as those referred to above.
- Develop appropriate guidance and training to respond to the issues raised in relation to the audit of revenue and group audits.
- Establish through the firm's internal quality reviews whether the nature of the issues raised with regard to the audit of IT controls indicates a need to improve the firm's guidance and training in this area.
- Ensure consistent application of the partner appraisal process and strengthen the link between the assessment of quality for each partner in all relevant areas and the overall ratings which determine pay awards.
- Improve the timeliness of completion of the firm's internal quality reviews such that the principal findings are addressed promptly and appropriately on the audits reviewed.

2. Principal findings

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

2.1. Reviews of individual audits

Follow-up of audits reviewed in the prior year

We undertook two follow-up reviews of audits we reviewed in the prior year. On one audit, all issues arising from our prior year review had been satisfactorily addressed, resulting in improvements to audit quality in those areas. On the other audit, however, while most of the issues were addressed there was still insufficient consideration of all relevant factors in the audit team's rebuttal of the presumption in Auditing Standards that there are significant fraud risks in relation to revenue recognition; and the testing performed of the controls covering certain revenue streams remained insufficient.

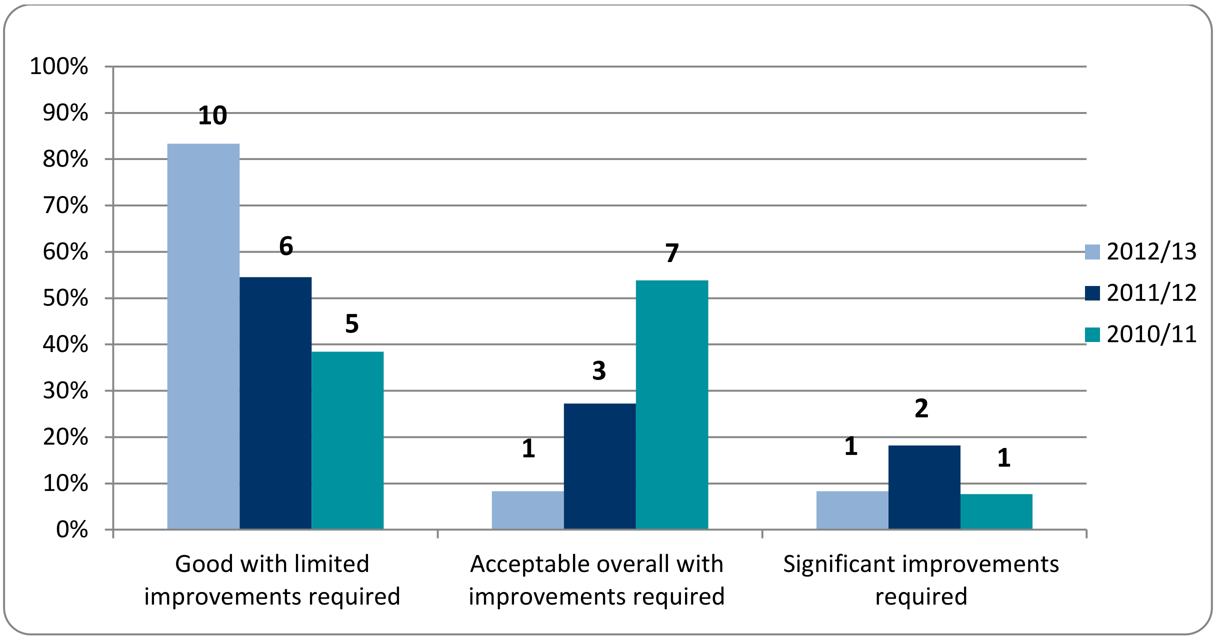
Audits reviewed in the current year

We reviewed and assessed the quality of selected aspects of twelve audits (2011/12: eleven audits).

Ten of the audits we reviewed (2011/12: six audits) were performed to a good standard with limited improvements required; one audit (2011/12: three audits) was performed to an acceptable overall standard with improvements required; and one audit (2011/12: two audits) required significant improvement in relation to revenue recognition, impairment of goodwill and group audit considerations.

An audit is assessed as requiring significant improvement if we 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 2012/13 falling within each grade, with comparatives for 2011/12 and 2010/11.



Changes to the proportion of audits reviewed falling within each grade 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, changes to our areas of particular focus and the scope of the individual reviews. For this reason, and given the small sample sizes involved, changes in gradings from one year to the next are not necessarily indicative of any overall change in audit quality at the firm.

Findings in relation to audit evidence and judgments

Our reviews focused on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk. We draw attention to the findings set out below which the firm should ensure are addressed appropriately in future audits.

The implication of such findings for our grading of an audit depends on their significance in the context of the individual audit. Even where our overall assessment of an audit was that the improvements required were limited in nature, we include the relevant findings in this report if we consider them important in the broader context of improving audit quality at the firm.

Recurring findings

In response to our prior year findings, the firm has taken steps to achieve improvements and has emphasised the requirements in the relevant areas through training and communications to the audit practice. We noted an improvement in quality compared with the prior year and recurring findings arose on a smaller number of audits in the current year. However, findings continued to arise in relation to substantive analytical review, the audit of goodwill impairment assessments, group audit considerations and reporting significant audit findings and independence threats and safeguards to the Audit Committee (see below). These areas continue to require improvement and we expect the firm to take further action to address them.

Revenue recognition

The audit of revenue was reviewed on all audits in the sample we selected. In six audits we identified issues in this area including, in two of them, issues regarding the recognition of revenue from long-term contracts. In one of these audits, no justification was given for the sample size and why it was considered adequate. Also, the sample of contracts was selected from ten months' rather than a full year's information. Further, in two audits insufficient audit procedures were performed and evidence obtained in relation to deferred revenue.

Analytical review procedures are frequently used to obtain substantive evidence in the audit of revenue. Weaknesses were identified in relation to aspects of the application of substantive analytical procedures in four audits, including expectations either not being set or not being set with sufficient precision and explanations obtained from management not being corroborated.

Impairment of goodwill

We reviewed the impairment of goodwill in eight of the audits we selected. On three audits issues were identified with the procedures performed in this area. In two of these audits there was insufficient evidence of assessment of the reasonableness of the growth rates or other assumptions, the reliability of the source data and appropriateness of the methodologies used by management in their impairment review. In one of these audits the audit team did not exercise appropriate professional scepticism in reaching their conclusion in this area.

Group audit considerations

We assessed the quality of the firm's audit work in this area on the ten audits in our sample where group audit considerations were applicable. In six audits, we identified issues with either the sufficiency of the group audit team's involvement in component auditors' risk assessments or the extent of their review of component auditors' work. Further, in one of these audits the group audit team's assessment of the extent of audit work required in relation to each component was based on profits at the half year stage and not updated for the full year results. The scoping for this audit should also have considered other key financial data including revenue and assets and whether a component otherwise gave rise to a significant risk of material misstatement.

Testing of internal controls

We considered aspects of the audit team's work on internal controls in the majority of audits selected and in two audits we specifically selected IT general controls for review. In these two audits, we identified issues relating to the testing of internal controls. In the first of these audits, it was not clear whether appropriate levels of testing had been performed in each area or whether all controls identified as responding to areas of significant risk had been tested appropriately. In the second of these audits, there was insufficient evidence that, as part of obtaining an understanding of the control environment, the audit team had evaluated whether the effectiveness of internal controls, including the controls on which they were planning to rely, had been undermined by deficiencies in password controls.

Other findings

Reporting to Audit Committees

We included this area in the review of all audits in our sample. Although there was no common theme, we identified significant matters that had not been adequately reported to the Audit Committee in three audits. These were the lack of communication in writing of the audit team's planned involvement in the work of component auditors; the fact that the audit team had not relied on IT general controls due to control weaknesses previously identified and the audit findings in this area; and the lack of communication of non-audit services provided during the period and details of the specific threats and safeguards in place.

Audit acceptance procedures

For one new audit, there was no evidence that the audit team had made appropriate enquiries of the previous auditors. In particular, there was evidence of a disagreement between management and the previous auditors regarding a proposed accounting treatment and this matter had not been appropriately considered by the audit team in accordance with the firm's audit acceptance procedures.

2.2. Review of the firm's policies and procedures

The firm's policies and procedures are largely developed globally and are implemented at an EY Europe level. The UK firm commits significant resources to their implementation at both a global and regional level; particularly in relation to independence compliance and monitoring procedures, risk assessment, audit training and technical communications, and the quality monitoring of audit engagements.

As in prior years, a list of "hot topics" was issued to all audit staff summarising the key areas of focus relating to audit quality for 2012 year end audits. Underpinning the list of hot topics was the application of professional scepticism in all aspects of the audit. The firm's mandatory training included specific training on professional scepticism using case study examples.

The list of hot topics formed part of the firm's response to our prior year findings and included key messages on the audit of revenue, substantive analytical review, impairment and group audits as well as independence threats and safeguards. These areas were a key component of the firm's mandatory training during the year.

Improvements made during the year

The majority of our prior year findings have been satisfactorily addressed by the firm in the current year. In particular, improvements have been made to the firm's procedures in the following areas:

The process for determining audit partner quality ratings for the purposes of partner performance evaluations and remuneration was revised during the year. The assessment of a separate quality rating for each partner remains under the oversight of the firm's Quality & Risk Management function ("Q&RM") but is now determined for each partner independently of the business unit by a panel of audit partners, including the UK&I Head of Audit, with responsibility for audit quality and compliance. In addition, the UK&I Head of Audit attends roundtable meetings with the reviewing partners for each business unit to discuss and moderate where appropriate the ratings for each partner. However, see findings below.

Staff performance evaluation processes have been revised to require a separate performance rating for audit quality (in prior years this was only a requirement for partners) which now has a direct impact on remuneration.

The firm has revised its internal quality monitoring processes ("AQR") to include more detailed testing of the firm's policies and procedures. This aspect of the AQR process, which was previously carried out by members of the UK firm, is now performed by senior technical staff from another network firm to promote a greater degree of objectivity.

Findings in the current year

We identified certain areas where improvements to the firm's policies and procedures are required, as set out below, which need to be addressed.

Partner performance evaluations and remuneration

Partner appraisals are not conducted or evidenced on a consistent basis and a variety of templates and formats are used. Although the self-assessment is generally completed in sufficient, relevant detail and we noted improvements in this area this year, the assessment by the reviewing partner or partners did not in a number of cases give a clear, comprehensive and balanced account of the partner's performance.

While in most cases performance ratings had been completed as required for each of four areas, including quality, together with an overall rating, there was insufficient evidence of consideration as to whether objectives had been met and appropriate goals had been set to address development needs identified. For five of the partners in our sample there was either no assessment or an inadequate one by the reviewing partner. In the case of three of these five partners and a further three, the appraisal form had not been signed off by the reviewing partner. Also, nine of the appraisals reviewed had been completed over two months after the deadline with no explanation as to why this had occurred.

One partner in our sample referred to non-statutory assurance services provided to two entities audited by him in assessing his achievements. Therefore evidence remains that some partners continue to seek credit for the sale of non-audit services to entities that they audit.

Since the UK firm is part of EY Europe, reviewing partners may be based in a firm outside the UK. In one appraisal within our sample, a reviewing partner from elsewhere in Europe encouraged the partner being assessed to improve non-audit/audit fee ratios at audited entities for which he was responsible. While this was identified by the partner being appraised as not being in accordance with Ethical Standards and reported to the management team, the firm must ensure that reviewing partners based outside the UK are made aware of UK ethical requirements in this area and the need to comply with them.

The independent assessment by QRM of each partner's quality rating is an effective mechanism for determining whether any evidence of poor quality should restrict a partner's overall rating. However, the sample reviewed indicated that a broader range of quality indicators should be considered across each partner's portfolio of work and there should be more evidence of the link between this assessment and the overall rating.

Monitoring of secondments to audit clients

In the current year, the firm changed its policy to allow secondments to audit clients on a limited basis in compliance with Ethical Standards. Any proposed secondments are required to be processed through the firm's normal review and approval procedures for non-audit services. However, the firm does not have a process in place for central notification of these secondments and, as a result, is unable to undertake monitoring procedures to ensure that the new policy is being correctly applied and that the requirements of Ethical Standards are being met.

Independence and ethics - error in the independence policy

The EY Global independence policy permits extended audit services if they have been authorised by the audited entity's management. However, Ethical Standards require authorisation by those charged with governance. We raised this issue in our prior year report but noted during our inspection this year that the error remained in the current version of the firm's policy.

Materiality for specific accounts/disclosures

The firm's audit methodology, which is developed and updated by EY Global, requires audit teams to consider whether there are any accounts or disclosures where the occurrence of misstatements of a lesser amount than the materiality level set for the financial statements as a whole could reasonably be expected to influence the users of the financial statements. However, Auditing Standards also require audit teams to determine a materiality level for such items and this was not reflected in the firm's methodology.

In addition, the firm's guidance on the calculation of materiality on pension scheme audits leads audit teams to use 2% of net assets as a basis for the calculation of materiality. This results in the use of materiality levels that are in some respects too high, particularly in relation to the audit procedures performed on the fund account and contributions summary.

Audit quality monitoring – timeliness of completion of reviews

Audit quality reviews of individual engagements were carried out during the period from April to July 2012. In the sample of reviews that we selected, there were two reviews where the process had not been completed by the end of the year. These were audits where the firm's internal review procedures had identified significant issues in relation to the audit work performed. File review findings and resulting actions should be finalised and addressed promptly and appropriately on the audits reviewed.

Other matters

Transparency report

We reviewed the firm's transparency report for the year to 29 June 2012, which was published in September 2012, to assess whether the information in the report was consistent with our understanding of the firm's quality control and independence procedures. We did not identify any such inconsistencies.

Off-shoring

The Assurance practice continues to use the services of the firm's Shared Services Centre overseas to conduct audit work of a more routine nature or in low risk areas of the audit. The audit work that may be off-shored is restricted by guidance issued by the firm.

Andrew Jones
Director
Audit Quality Review
FRC Conduct Division
31 May 2013

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 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 also assess the extent to which the firm has addressed the findings arising from its previous inspection.

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 which require action by the firm than areas of strength and are not intended to be a balanced scorecard or rating tool.

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 professional accountancy bodies in the UK register firms to conduct audit work. Their monitoring units are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection but within the scope of audit regulation in the UK. Their work, which is overseen by the FRC, 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 the work which we carried out for the purposes of our inspection.

Basis of reporting

We exercise 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 our 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. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

While our 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 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 our 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. As a result, there may be a significant period of elapsed time between the completion of our inspection fieldwork at a firm and the publication of a report on the inspection findings.

We also issue confidential reports on individual audits reviewed during an inspection. These reports are addressed to the relevant audit engagement partner or director but firms are expected to provide copies to the directors or equivalent of the relevant audited entities.

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 and its 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.

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16 May 2013

Dear Sirs

FRC Public Report on the 2012/13 Inspection of Ernst & Young LLP

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

We are pleased the FRC's report recognises our emphasis on audit quality, commenting on the significant resources we commit both globally and regionally to the implementation of policies and procedures, particularly in relation to independence compliance, risk assessment, audit training and technical communications.

The FRC's report highlights an overall improvement in audit quality, which is reflected in the high proportion of our audits reported in the FRC's top quality category. The report also identifies recommendations for further improvement. Whilst we do not always share the FRC's view on the significance of individual matters, we value the FRC's recommendations and have already implemented a number of actions in response.

In wider debates around corporate governance and the regulatory focus on our industry we share with the FRC a common objective of promoting confidence in the UK capital markets by, among other things, continuous improvement in audit quality. We continue to invest in our business to achieve that.

Yours faithfully

Hywel Ball
Managing Partner Assurance, UK & Ireland
Ernst & Young LLP

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