



Financial Reporting Council

ERNST & YOUNG LLP

AUDIT QUALITY INSPECTION

JULY 2019

The FRC

Our mission is to promote transparency and integrity in business.



We have responsibility for the public oversight of statutory auditors.

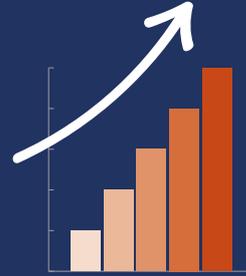
The FRC works with European, US and global regulators to promote high quality audit and corporate reporting.



AQR

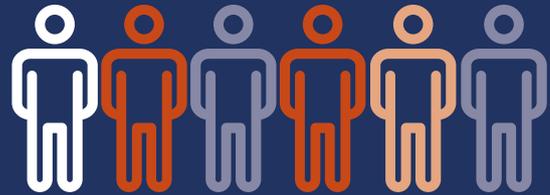
We monitor the quality of UK Public Interest Entity audits.

+155	0.20%	+2.27%	-11.48%	POS	-3.2320
+320	0.21%	+2.83%	-15.93%	NEG	-3.9993
+365	0.14%	+2.42%	-17.67%	POS	-4.2421
+338	0.27%	+2.19%	-18.32%	NEG	-4.2083
+320	0.27%	+2.28%	-14.73%	NEG	-3.5708
+370	0.26%	+2.76%	-20.12%	NEG	-2.8339



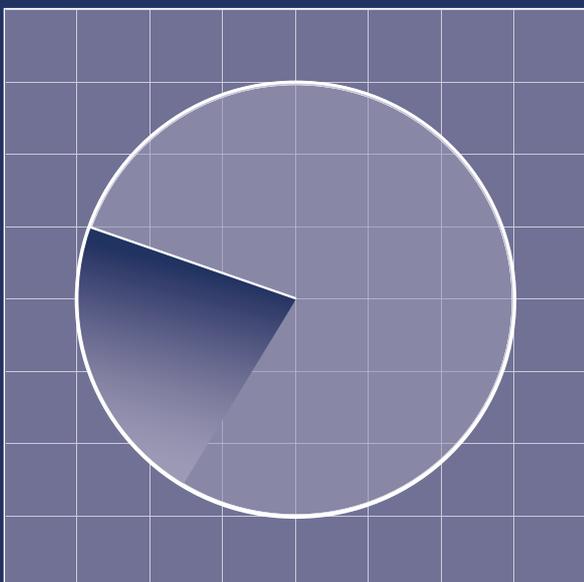
We promote continuous improvement in audit quality.

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



The Firm

EY has 324 audits within the scope of AQR inspection, including 15 FTSE 100 and 44 FTSE 250 audits.



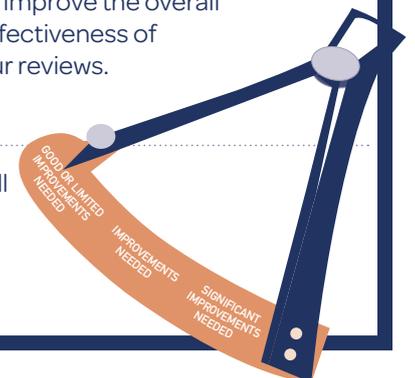
Our inspection process

There are around 2300 audits within the scope of AQR inspection. In total, we inspected 160 individual audits in 2018/19, 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

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.

We consider whether action under the FRC's enforcement procedures is appropriate for all reviews assessed as requiring improvements or significant improvements. In practice, audits assessed as requiring significant improvement, and some of those assessed as requiring improvement, will be referred to the FRC's Case Examiner for consideration of further regulatory action. The Case Examiner will consider the most appropriate action, including Constructive Engagement with the audit firm or referral to the FRC's Conduct Committee for consideration of whether to launch a full investigation. This may result in a sanction being imposed and enforced against a statutory auditor and/or the audit firm in accordance with the FRC Audit Enforcement Procedure.

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This report sets out the principal findings arising from the 2018/19 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 February 2018 to February 2019 ("the time of our inspection"). We inspect EY, and report publicly on our findings, annually.

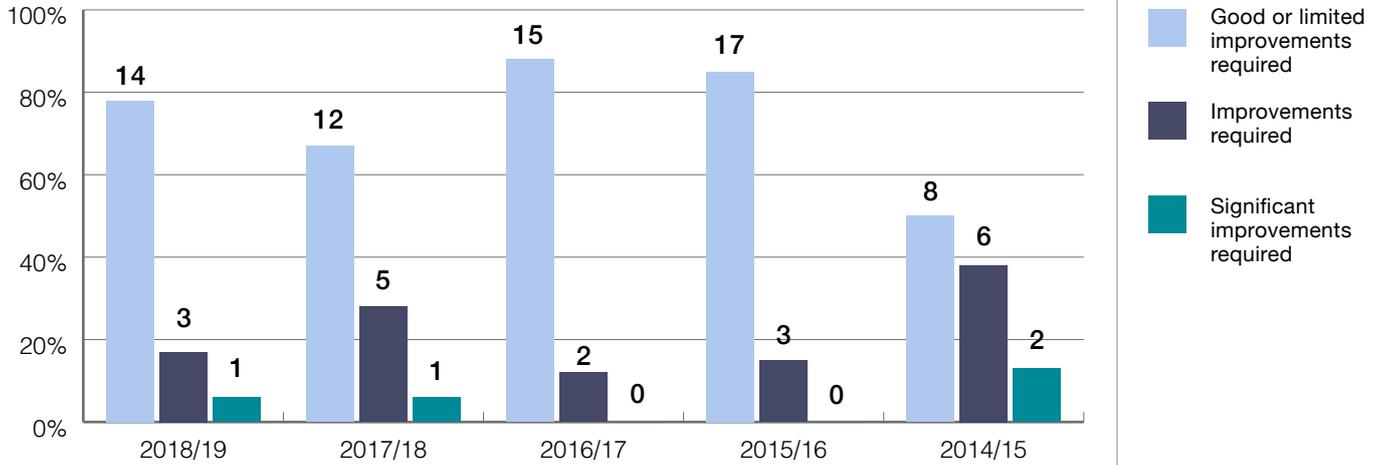
Our report focuses on the key areas requiring action by the firm to safeguard and enhance audit quality. It does not seek to provide a balanced scorecard of the quality of the firm's audit work. Our findings cover matters arising from our reviews of both individual audits and the firm's policies and procedures which support and promote audit quality. This year, our firm-wide work, performed on a three year cycle, focused on internal quality monitoring, engagement quality control reviews and independence and ethics.

Our priority sectors for inspection in 2018/19 were general retailers; oil and gas producers; support services companies; and financial services. Of the 139 audits that we reviewed in the year across all firms (excluding Local Audit inspections), the number in priority sectors was: General retailers (11); Oil and Gas producers (7); Support services (13); and Financial services (34).

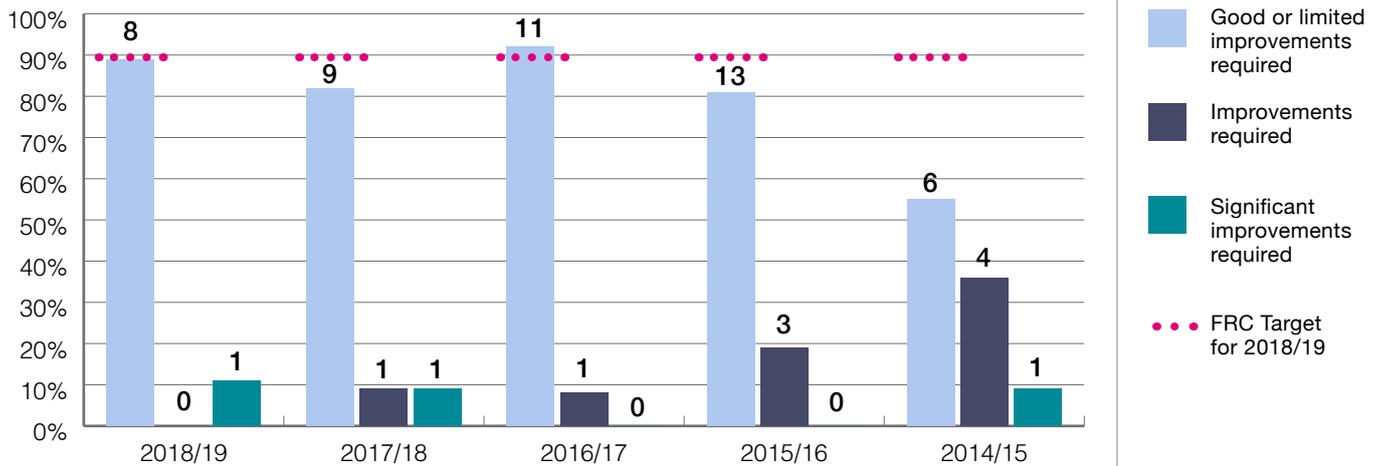
We also paid particular attention to the following areas of focus: changes in auditor appointments; audit of fair value investments (including goodwill impairment); the use of auditor's experts and specialists; and the audit of controls.

Our assessment of the quality of audits reviewed

Ernst & Young



FTSE 350



Changes to the proportion of audits falling within each category reflect a wide range of factors, including the size, complexity and risk of the audits selected for review and the scope of individual reviews. Our selections, which are primarily risk-focused, are also informed by the priority sectors and areas of focus referred to above. For these reasons, and given the sample sizes involved, changes from one year to the next cannot, on their own, be relied upon to provide a complete picture of a firm's performance and are not necessarily indicative of any overall change in audit quality at the firm.

Any inspection cycle with audits requiring more than limited improvements is a cause for concern and indicates the need for a firm to take action to achieve the necessary improvements.

1 Overview

The FRC set a target for the firms that at least 90% of FTSE 350 audits should be assessed as requiring no more than limited improvements by the end of the 2018/19 inspection cycle. Regrettably, no firm inspected this year achieved the target.

As a result, we will, for 2019/20:

- Continue to measure firms' audit quality against the 90% FTSE 350 target and expect all firms to meet that target.
- Extend the 90% target to all other audits within the scope of our inspection.

Stakeholders rightly demand high quality work on all audits and they would expect, we believe, that all audits subject to our review should require no more than limited improvements. We will therefore, for 2020/21 onwards, set a new target for audit firms that 100% of audits should require no more than limited improvements.

All the firms reviewed have performed root cause analysis and identified a number of themes relating to why the audits we inspected did not always meet the required standard and why certain findings recur over a number of years. These themes, across the firms inspected, include insufficient scepticism and weaknesses in project management or resourcing. In addition, the analysis also highlighted inconsistent execution of firms' audit methodologies and quality control procedures. Firms' actions should be targeted and responsive to the findings from their root cause analysis to achieve the required improvements in audit quality.

We will continue to take robust action for all reviews assessed as requiring improvements or significant improvements. To date, for the past two inspection cycles, we have referred 16 audits, across all firms inspected, to the Case Examiner for consideration of further enforcement action. In these cases, we further scrutinise the root cause analysis undertaken by the firm and the actions taken by the firm in response to our findings and consider what additional action we can take to ensure audit quality.

Key findings for EY

We assessed 78% of the firm's audits that we reviewed as requiring no more than limited improvements, compared with 67% in 2017/18. Of the FTSE 350 audits we reviewed this year, we assessed 89% as achieving this standard compared with 82% in 2017/18.

Our key individual review findings related principally to the need to:

- Increase the challenge and corroboration of management assumptions in relation to intangible assets.
- Improve reporting from the firm's internal specialists on the key assumptions underpinning the estimation of provisions.

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- Ensure consistency of the group audit team's oversight of component audit teams.

We had no significant findings arising from our firm-wide work on internal quality monitoring, engagement quality control reviews and independence and ethics.

Given our key individual review findings noted above, however, this would indicate that the firm's quality control procedures have not been sufficiently effective to achieve the necessary improvement in audit quality.

Further details of our key findings are given in section 2, together with the firm's actions to address them.

Good practice identified and developments in the year

We identified examples of good practice in the course of our work, including group audits and the challenge of management assumptions. These, together with firm developments in the year, 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.

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.

Given that no firm this year has met the FTSE 350 target, firms need to re-appraise whether their RCA accurately identifies the causes of our inspection findings and whether their actions are properly linked to those causes. In particular, the firms should increase their focus on systemic issues behind the findings as well as the findings on each individual audit.

Firm's overall response and actions:

We are committed to conducting audits of the highest quality, knowing their importance in helping to sustain stable capital markets. It is fundamental to our business and our public service obligations.

We recognise the importance of the various current reviews into corporate reporting and audit and will continue to play an active and constructive role. We believe the right set of changes in the nature of audit and the regulation of both auditors and the governance of companies is needed to ensure the audit profession meets the evolving needs of stakeholders, while also enhancing protection for UK pensioners, employees and investors in the future.

We are pleased that the results of this year's FRC inspection show an increase in both the overall percentage of all audits and the FTSE 350 audits inspected by the FRC graded as good or requiring no more than limited improvements. However, we are disappointed that one of our FTSE 350 audits was identified as requiring significant improvements meaning 89% of our FTSE 350 audits met this standard against the FRC target of 90% and we recognise the further efforts that we need to make to deliver consistent high audit quality and achieve the new targets that the FRC has set.

In 2014 we established our Audit Quality Board to drive improvements in our audit quality and the Board continues to have responsibility for all matters relating to audit quality, reporting to the main board of EY and to the Independent Non Executive Oversight Committee. The Audit Quality Board sets the agenda for our Sustainable Audit Quality Programme and oversees matters that could impact audit quality including, but not limited to, focused initiatives to share best practice and support teams, as well as considering regulatory requirements, resourcing, root cause analysis and remuneration. As noted above there is more we need to do to improve audit quality but we are proud of what our programme has achieved over the last five years. We are pleased the FRC identified improvements in relation to all key findings highlighted in last year's report. It is also encouraging to see many areas of good practice identified by the FRC on individual audit inspections as well as from the firm-wide procedures conducted.

Our root cause analysis of the FRC's findings and our own quality reviews continue to be important inputs into our Sustainable Audit Quality Programme and we intend to increase significantly our investment in it for 2019/20 and beyond. The root cause analysis tells us that the factors key to our good quality results continue to be; the culture we have developed at EY, our audit team behavioural model, a high degree of executive involvement, the support provided to audit teams by our Audit Quality Support Team, more consistent use of new technology and enablers, effective team resourcing and good organisation at the companies we audit.

Our root cause analysis informs our actions in response to deficiencies identified. In Section 2 of this report, we set out the actions we took during the period of the FRC's inspection to address their key findings, together with the additional actions planned. In particular, in relation to the engagement identified as requiring significant improvement we are reviewing our controls to detect and address situations where individuals are working under excessive time pressure.

We continue to make significant investment in our Sustainable Audit Quality Programme. We detail below some of our priorities:

- Reinforcing the importance of our culture in supporting continuous improvement in audit quality. This provides the environment for all initiatives to drive improvements and reinforces the need for auditors to apply the principles of rules and standards as well as live by the spirit in accordance with public expectations.
- Our audit team behavioural model, based on cognitive psychologists' research into exceptional audit quality, has been successful in improving audit quality. We are continuing to increase the extent and consistency of the implementation of this valuable way of working. During the last year we have enhanced the model to bring greater focus on our responsibilities to shareholders and have held roadshows and briefings across the whole of the UK audit practice. We have also introduced a feedback mechanism specific to this initiative so we can continue to refine this way of working.
- Resources for our Audit Quality Support Team, which supports certain audit teams, have been increased. The team has expanded its best practice sharing role and is responding more proactively to higher risk areas. We will be further increasing the number of audits supported by the team.

We also recognise the fundamental importance of our overall quality control processes. We believe that we have a strong firmwide quality control framework; however, we have already started our programme to respond to and implement the requirements of the forthcoming International Standard on Quality Management (ISQM 1) which will further strengthen that structure.

Audit quality remains our highest priority. We believe that we are taking the right actions to enable us to improve audit quality further. We welcome the FRC's independent inspections. We have listened carefully and responded to the feedback provided. We would like to thank the FRC for its work and the insights 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, where relevant, 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 challenge and corroboration of management assumptions in relation to intangible assets

Recognition of intangible assets, including the capitalisation of internally-generated product development costs in accordance with IAS38, requires management judgement. The estimates and assumptions applied to support the amount capitalised and the value of other intangible assets may be subject to management bias. Auditors should challenge both the reasonableness of the basis for capitalising these costs and management's key assumptions which support the carrying value of all intangible assets.

Findings

We reviewed the audit of intangible assets including capitalised product development costs on the audit of six entities. On two audits we identified cases where audit teams obtained insufficient evidence to conclude on the appropriateness of development costs capitalised or that further impairments were not required, including the following:

- Insufficient corroboration of key forecasts used to support the carrying value of selected projects or other intangible assets.
- Insufficient investigation or corroboration of the reasons for differences identified in the items selected for testing.
- Inappropriate reliance on audit evidence from prior periods and walkthrough testing.

Firm's actions:

Our root cause analysis identified that the findings on these two audits resulted from insufficient senior resource following changes in audit timetables and complex issues that arose during the audits. This was exacerbated by one key team member being involved in both audits simultaneously, creating time pressures which meant that the detailed review that is routinely conducted and would detect inadequacies in the testing was not performed in sufficient depth. The issues noted in the FRC's review were therefore not detected by EY's normal review.

We have controls in place which are designed to detect when individuals are working hours that are above our expectations so that EY management can intervene and act if the individuals have not raised the fact they are under time pressure. Those controls did not prevent this situation arising. We are reviewing the design of these controls to ensure that any similar situations are detected and dealt with on a timely basis. We will also continue to reiterate the importance of all our people seeking further support when they require it.

We will also continue to emphasise the importance of thorough and timely review which will be facilitated using the behavioural model alongside our project management programme to ensure timely completion.

Improve reporting from the firm's internal specialists on the key assumptions underpinning the estimation of provisions

Establishing outstanding provisions, including insurance claim reserves, involves significant judgement and may be subject to conscious or unconscious management bias. Audit teams engage the firm's internal specialists to assist auditors given the specialised nature of the calculations and assumptions. Auditors should obtain sufficient evidence to assess whether management's assumptions and methodologies were reasonable.

Findings

The audit of financial services entities was an area of focus for our 2018/19 inspection. Our work included assessing the involvement of the firm's specialists to support the audit teams. We used FRC banking and actuarial expertise to review the specialists' work to support the audit teams' conclusions on the appropriateness of provisions.

Generally, we found a good level of involvement from the firm's specialists in the support of the audit teams. However, for two non-life insurance entity audits, the reporting from actuarial specialists did not provide sufficient detail for the audit partner to conclude on the appropriateness of the provision for claims outstanding. We identified the following examples where there was insufficient explanation in the reporting from the firm's actuarial specialists and experts for the audit team to conclude on:

- Key areas of judgement, including the impact of adopting higher or lower loss ratios and the nature of key reserving uncertainties.
- The level of uncertainty around catastrophe uncertainties.
- The justification for changes in management margin.

Firm's actions:

We have put a great deal of focus on the use of specialists in our audits so we are therefore pleased that the FRC identified that generally there was a good level of involvement from the firm's specialists in the support of the audit teams.

Our root cause analysis identified that our teams on audits with findings in this area had appropriately included the actuaries as team members with specialist knowledge and they had considered the relevant matters. The audit files should have included the detailed working papers prepared by the actuaries as well as their final report. However, in these instances the teams did not stand back to consider whether the file reflected the level of challenge and rigour that had been applied or ensure that the full set of actuarial working papers were included in the final audit file.

We have held training sessions with actuarial partners and managers alongside the audit teams to reiterate the expectations in relation to actuarial working papers and the level of detail that should be included in the audit files. In addition to this we have developed a standard list of actuarial working papers that teams should expect to include on the audit file.

Ensure consistency of the group audit team's oversight of component audit teams

Most audits within our scope are group audits comprising both group and component audit teams. The group audit team should direct, supervise and review the work of component audit teams and evaluate the appropriateness of audit evidence obtained and the conclusions reached to support the group audit opinion.

Findings

On most audits reviewed, we consider aspects of the group audit including how the audit work was scoped; the instructions issued to those performing audit work on financial information relating to components of the group; the extent of the group auditor's involvement in component auditors' work; the group auditor's evaluation of component auditors' work; and how issues reported by component auditors were followed up and resolved.

We identified examples of good practice in relation to group auditor involvement. Notwithstanding this, we also identified the following weaknesses:

- On three audits, there was insufficient evidence of the nature and extent of the group audit team's involvement and oversight of aspects of the component auditors work.
- On another audit, analytical procedures on "not significant components" were insufficient to ensure all movements in balances in excess of materiality were investigated.

Firm's actions:

When the International Standard on Auditing (UK) 600 "Specialist Considerations – Audit of Group Financial Statements (including the Work of Component Auditors)" was revised in June 2016 we updated our guidance and templates on the changes necessitated by this revision. We are pleased that the majority of our teams have responded well to these changes, and good practices have been identified by the FRC.

Our root cause analysis indicates that the teams identified by the FRC did not make the change required to increase and evidence the nature and extent of the primary team's involvement in the oversight of components. In response to emerging findings from the FRC's inspection we issued new guidance clarifying the requirements and considerations of ISA 600. This considered the Staff Guidance Note issued by the FRC during November 2018 covering Group Audits. The guidance developed included an addendum to our template to record the interactions with component teams.

The audit where this finding was the most pronounced was an audit also referred to within the finding on development costs. The root causes identified for that issue were also root causes for this matter.

Other issues driving lower quality audit assessments

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

- Insufficient audit procedures to confirm the completeness and accuracy of data used in the analytical procedures applied to audit revenue in an entity with high volume and highly automated transactions.
- Insufficient assessment and challenge to conclude on forecast profits supporting the recovery of deferred tax assets.

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

The group auditors' extent of involvement in the work of component auditors

In the majority of audits reviewed, we considered the group audit team's direction and supervision to be of a high standard. We particularly noted that on a number of groups which were not UK-based, the integration of the group audit team in the work of the component audit teams, including the split of the responsibilities between the teams and the group team's oversight of the component teams, was of a high standard.

Challenge and assessment of management's key assumptions in relation to financial services entities

We reported last year that the firm needed to demonstrate an appropriate level of challenge and professional scepticism when considering management assumptions used in the estimation of conduct provisions in financial services entities. On the banking audits we reviewed, we identified examples of good practice where the audit teams obtained good corroborative evidence supporting the audit of conduct provisions and loan loss impairment. This demonstrated strong challenge of management assumptions.

Effective quality control procedures

We identified examples of effective quality control procedures including effective challenge of the audit engagement team by the engagement quality control reviewer.

Clear reporting of audit judgements and conclusions in areas of significant risk

We identified examples of a high standard of reporting to the Audit Committee in areas of judgement relating to insurance provisions, investment properties and investment valuations. In one case, there was a particularly clear explanation in the Auditor's Report of the application of materiality and how the audit had addressed key audit matters.

Deferring audit sign-off

We noted deferring the signing of the auditor's report until the audit team had obtained and reviewed key audit evidence and ensured that robust control procedures had been completed.

Firm-wide procedures

Regular monitoring of consultations on high risk entities

The firm centrally monitors consultations on high risk clients on a quarterly basis and investigates where no consultation has occurred.

Developments in the year

In response to the findings in our 2018 report, the firm identified the audit of banks as an area for training and support from the Audit Quality Support Team (AQST). We have seen an improvement in all the key findings we highlighted in last year's report.

The firm has continued to roll out its Sustainable Audit Quality Programme, including:

- Increasing AQST resources to carry out hot reviews of a sample of FTSE 350 and other major public interest audits and to provide real-time feedback and coaching to audit teams.
- Increasing consistent implementation of the firm's audit team behavioural model. This includes mandatory discussion on the auditor's purpose and how the auditor serves shareholders and the wider public interest.

In response to our key firm-wide findings in last year's report, the firm has:

- Implemented revised policies on the thresholds for gifts and hospitality provided to and received from audited entities; and
- Amended its acceptance procedures to ensure that its central independence team monitors the permissibility of non-audit tax services for public interest entities.

We note the co-operation and assistance received from the partners and staff of the firm in the conduct of our 2018/19 inspection.

Audit Quality Review

FRC Audit and Actuarial Regulation Division

July 2019

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