Audit Inspection Unit

Public Report on the 2011/12 inspection of Ernst & Young LLP

15 June 2012

This report is issued by the FRC's Audit Inspection Unit. It has been approved for publication on behalf of the Professional Oversight Board.

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1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the inspection of Ernst & Young LLP ("EY" or "the firm") carried out by the Audit Inspection Unit ("the AIU") of the Financial Reporting Council ("the FRC"), in respect of the year to 31 March 2012 ("the 2011/12 inspection"). Our inspection was conducted in the period from April 2011 to February 2012 (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 11 audit engagements undertaken by the firm in our 2011/12 inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between October 2010 and March 2011. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit.

Each year we select a number of areas of particular focus. For 2011/12, these were: group audit considerations; the valuation of assets held at fair value; the impairment of assets (including goodwill and other intangibles); the assessment of going concern; revenue recognition; related parties and the quality of reporting to Audit Committees.

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 audits.

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

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

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. 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 actions taken and planned will be reviewed during our next inspection.

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

The AIU acknowledges the co-operation and assistance received from the partners and staff of EY in the conduct of the 2011/12 inspection.

1.2 Background information on the firm

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

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

For the year ended 1 July 2011, the firm's turnover was £1,465 million, of which £444 million related to the Assurance service line. There was a total of 540 partners, of whom

116 were authorised to sign audit reports, and 64 employees who were authorised to sign audit reports.[1]

The AIU estimates that at 28 February 2011 the firm audited 269 UK entities within the scope of independent inspection by the AIU. Of these entities, AIU records show that 121 had securities listed on the main market of the London Stock Exchange, including 16 FTSE 100 companies and 30 FTSE 250 companies.

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 by the AIU under separate arrangements agreed with the relevant regulatory bodies and the principal findings of any such reviews undertaken in the year are included in this report. Our records show that the firm has 39 such audits, including two FTSE 100 companies and six 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 has appropriate policies and procedures in place for its size and the nature of its client base in most areas which are subject to our review. Nevertheless, we identified certain areas where improvements are required to those procedures, which 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 partners and staff, whose work and judgments ultimately determine the quality of individual audits.

1.4 Key messages

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

[1] As disclosed in the annual report for the year ended 1 July 2011

- Introduce more specific training in relation to the audit of goodwill impairment, including the assessment of the reasonableness of growth rates and the methodologies used by management in their projections.

- Review the training and audit guidance available in relation to the audit of revenue and, where appropriate, enhance it in the light of the issues raised in this report.

- Ensure that the firm's quality review processes place more emphasis on recurring findings from both internal and external inspections.

- Revise the appraisal process for senior staff so that audit quality is separately rated as well as providing an overall rating.

- Apply greater rigour in the assessment of partners' quality ratings and ensure that the quality of partners' relationships with the entities that they audit is not included in this assessment. Take action in relation to individual partners who have clearly sought credit in their appraisals for sales of non-audit services to entities that they audit.

2 Principal findings

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

2.1 Review of audit engagements

Follow-up of audits reviewed in the prior year

We undertook two follow-up reviews of audits we had reviewed in the prior year. The issues we raised in the prior year had been addressed on these two audits which resulted in improvements to audit quality in the relevant areas.

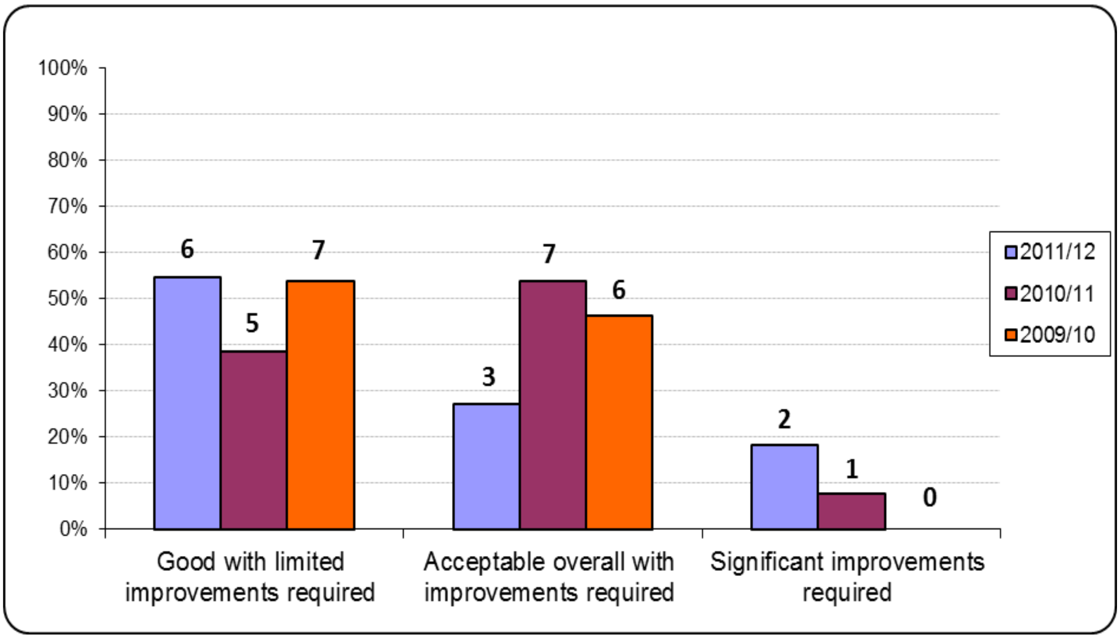
Audits reviewed in the current year

We reviewed and assessed the quality of selected aspects of 11 (2010/11: 13) audits.

Six of the audits we reviewed (2010/11: five) were performed to a good standard with limited improvements required; three audits (2010/11: seven) were performed to an acceptable overall standard with improvements required; and two audits (2010/11: one) required significant improvement; one in the audit of revenue and risk assessment and the other in both these and a number of other areas. Further details are set out under the headings below.

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

The bar chart below shows the percentage of the audits we reviewed in 2011/12 by AIU grade with comparatives for 2010/11 and 2009/10.



Changes to the proportion of file reviews 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 the AIU's areas of particular focus and the scope of the individual reviews. For this reason and because of the small size of the samples 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

The focus of our reviews was on the audit evidence and related judgments for material areas of the financial statements and areas of significant risk.

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

Impairment of goodwill and other assets

In response to issues identified in prior years, the firm emphasised the requirements in this area in its training and communications to the audit practice. However, on six audits, there was insufficient evidence of the work performed by the audit teams in assessing either the reasonableness of the growth rates or of the other assumptions, source data and methodologies used by management in their projections to assess the potential for impairment of goodwill. In three of these audits the audit teams did not apply sufficient professional scepticism in reaching their conclusion in this area.

- Revenue recognition

In six of the audits we reviewed, we identified issues in relation to the audit of revenue.

In one case, revenue recognition should, in our view, have been identified as a significant risk and further testing performed. In addition, on the same audit, insufficient evidence was obtained to support the conclusion that related internal controls were operating effectively. In both this audit and a further two audits, weaknesses were identified in relation to aspects of substantive analytical procedures, such as expectations not being set or not being sufficiently granular and explanations obtained from management not being corroborated.

- Group audit considerations

Auditing Standards applicable from December 2010 financial year-ends introduced more specific requirements for the conduct of group audits and the firm issued detailed guidance in this area. We identified issues in three audits.

In one audit the group audit team's involvement in component auditors' risk assessments and planned audit responses was insufficient. In another the audit team's evaluation of the sufficiency and appropriateness of the audit evidence obtained by the component auditors for group audit purposes required improvement.

- Audit sampling

In six of the audits we reviewed, we identified issues relating to the basis on which samples were selected for testing, including insufficient evidence to justify the sample selected in four audits.

Recurring findings from one year to the next

In response to our prior year findings, the firm has taken steps to achieve improvements. However, findings continued to occur in relation to goodwill impairment assessments, substantive analytical review, and group audit considerations (as detailed above); reporting significant audit findings and independence threats and safeguards to the Audit Committee, and risk assessment procedures (as detailed below). These matters continue to require improvement and we expect the firm to deal with them effectively.

Other findings in the current year

- Reporting to the Audit Committee

In two of the audits we reviewed, significant findings were not adequately reported to the Audit Committee. In one case the audit team should have communicated in writing the fact that the draft accounts presented for audit were not of an appropriate standard, due to the large number of errors identified by the firm's technical review.

On three audits we reviewed, we found that independence threats and the related safeguards adopted were not adequately reported to the Audit Committee. In two cases these related to the provision of non-audit services.

- Risk assessment procedures

In five audits we identified issues relating to risk assessment procedures, including insufficient consideration of certain areas of risk and related audit responses; and insufficient consideration of potential indicators of management bias in an area of key accounting judgment.

- Quality control and audit finalisation

The firm's quality control and audit finalisation procedures were generally performed to an acceptable standard. In two audits, however, there was insufficient evidence of review by the engagement partner or independent review partner. In a further two audits there were weaknesses in the assembly or archiving of audit files. In one audit, it was not clear that the unaudited sections of the Annual Report were consistent with the audited financial statements and there was inadequate evidence that the consistency of the unaudited information had been appropriately considered.

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.

During the year, the firm has emphasised the importance of the Engagement Quality Control Review (EQCR) role and updated its policies and procedures for partners performing this role. In particular, EQCRs are now required to describe the procedures that they have performed in key areas of the audit such as significant accounting, auditing and financial reporting matters, risks identified and judgments made by the engagement team on each review. It was evident from our meetings with three of the firm's EQCRs that the firm places considerable importance on the role of the EQCR and on ensuring that there is appropriate evidence of the review procedures performed.

The firm requires technical reviews of financial statements to be conducted before the completion of the audit for all listed entities. The review is performed by dedicated technical staff who are required to give clearance on all review points raised. This is a robust process which helps to ensure that financial statements comply with relevant accounting and disclosure requirements.

The firm has taken action during the year to ensure that appropriate professional scepticism is exercised on audits. Professional scepticism was included as the first item in the firm's "Hot Topics" list which was issued to all audit staff summarising the key areas of focus for 2011 year end audits. In addition, mandatory training events were held during the year which included case studies and other guidance on exercising an appropriate level of scepticism.

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

Progress on dealing with prior year findings

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

- An increase to the number of audits selected for review in the firm's internal quality monitoring processes (AQR) and a greater focus on group audit considerations during each file review. The firm has also put in place a process to ensure that it meets its target of covering each FTSE 350 entity that it audits at least once every six years (or justifies the reasons for not doing so and obtains appropriate approvals).

- Processes to resolve individual ethical compliance issues have been improved to ensure the timeliness of resolution and formal closure of exceptions raised during the firm's annual compliance process.

However, further action is required in the following areas:

- Staff performance evaluations

The current annual staff appraisal process does not require an individual's performance in relation to audit quality to be separately rated. Only an overall rating is required, rather than a rating for each scorecard area. The annual staff appraisal process should be enhanced by including a specific assessment relating to audit quality. We were informed that from the next appraisal year the firm is moving to a system whereby audit managers will have a separate rating for the firm's four scorecard areas.

In addition, for five managers in our small sample the completion of the appraisal form was inadequate and in five cases the manager's annual development plan had not been completed by the individual or completed and signed off as approved by the counsellor.

- Partner performance evaluations and remuneration

While the assessment of a separate quality rating for each partner under the oversight of the firm's Quality & Risk Management function (Q&RM) is a positive feature of EY's performance evaluation procedures, the finalisation of each partner's quality rating is insufficiently rigorous. As an example, on the basis of the evidence we reviewed, good feedback from an audited entity has a positive impact on the overall quality rating even when such feedback may not be specifically related to quality, but to the strength of the relationship with that entity. As a result it is not clear that evidence of poor quality audit work, such as a low grade arising from an independent quality review, is always adequately reflected in partner remuneration.

Further, three partners in our small sample sought credit within their annual appraisal forms for selling non-audit services and/or developing potential opportunities for selling other services to entities that they audit.

Other findings in the current year

- Partner promotions

One partner candidate obtained feedback from audited entities to support the case for promotion to partner. While we recognise that the firm may wish to seek feedback from audited entities in relation to partner candidates, allowing the candidates themselves to seek such feedback gives rise to a potential threat to their independence and objectivity.

- Approval of non-audit services

We noted a number of cases of approved non-audit services where threats to auditor independence and the safeguards applied by the firm had not been adequately considered. The firm has amended its process so that reasons must be provided where the audit team determines that no independence threat exists. It should also be made clear to staff that it is only possible for independence threats to be considered insignificant for those audit-related services specified in the Ethical Standards.

- Audit quality monitoring

The firm has a well-developed audit quality monitoring process for individual audits. There was limited evidence, however, of testing being performed in certain areas as part of its practice level reviews (for example, aspects of the review of learning and the assignment of personnel). The firm should develop a more comprehensive testing programme for all practice level reviews.

Andrew Jones
Director of Audit Quality
Audit Inspection Unit
FRC Conduct Division
15 June 2012

Appendix A – Objectives, scope and basis of reporting

Scope and objectives

The overall objective of our work is to monitor and promote improvements in the quality of auditing. As part of our work, we monitor compliance with the regulatory framework for auditing, including the Auditing Standards, Ethical Standards and Quality Control Standards for auditors issued by the FRC's Auditing Practices Board and other requirements under the Audit Regulations issued by the relevant professional bodies. The standards referred to in this report are those effective at the time of our inspection or, in relation to our reviews of individual audits, those effective at the time the relevant audit was undertaken.

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

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

Our inspection was not designed to identify all weaknesses which may exist in the design and/or implementation of the firm's policies and procedures supporting audit quality or in relation to the performance of the individual audit engagements selected by us for review and cannot be relied upon for this purpose.

The monitoring units of the professional accountancy bodies in the UK which register firms to conduct audit work are responsible for monitoring the quality of audit engagements falling outside the scope of independent inspection 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 work carried out by the AIU.

Basis of reporting

This report is based on the AIU's more detailed private report on its inspection of the firm to the Audit Registration Committee ("the ARC") of the Institute of Chartered Accountants in England and Wales ("the ICAEW") with which the firm is registered for audit purposes. The AIU currently inspects the largest audit firms including Deloitte annually. The ARC considers whether audit registration should be continued for the firm following each inspection undertaken. The AIU's report to the ARC, which was finalised in April 2012, recommended that the firm's registration to conduct audit work should be continued.

The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year. In relation to reviews of individual audits, we have generally reported our findings by reference to important matters arising. Where appropriate, we have commented on themes arising or issues of a similar nature identified across a number of audits.

While the AIU's public reports seek to provide useful information for interested parties, they do not provide a comprehensive basis for assessing the comparative merits of individual firms. The findings reported for each firm in any one year reflect a wide range of factors, including the number, size and complexity of the individual audits selected for review by the AIU which, in turn, reflects the firm's client base. An issue reported in relation to a particular firm may therefore apply equally to other firms without having arisen in the course of the AIU's inspection fieldwork at those other firms in the relevant year. Also, only a small sample of audits are selected for review at each firm and the findings may therefore not be representative of the overall quality of each firm's audit work.

The fieldwork at each firm is completed at different times during the year and comprehensive quality control procedures are applied before the AIU's private and public reports are finalised. As a result, there may be a significant period of elapsed time between completion of the AIU's inspection fieldwork at a firm and the publication of a report on the inspection findings.

The AIU also issues confidential reports on individual audits reviewed during an inspection which are addressed to the relevant audit engagement partner or director. Firms are expected to provide copies of these reports 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

Ernst & Young LLP
1 More London Place
London SE1 2AF

Tel: 020 7951 2000
Fax: 020 7951 1345
www.ey.com/uk

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

7 June 2012

Dear Sirs

AIU Public Report on the 2011/12 Inspection of Ernst & Young LLP

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

Auditors play a vital public interest role in promoting the transparency that underpins confidence in the world's capital markets - independent audit inspection is important in helping to further the quality of audit work and enabling the auditor's role to become more transparent to our stakeholders. We believe the key factors needed to deliver high quality audits in today's global companies are diverse talent, a globally integrated approach, professional scepticism and technical excellence.

We are therefore pleased to note the positive comments made by the AIU in relation to the robustness of our process for technical reviews of financial statements as well as the importance we place on the role of our engagement quality control review partners. We are also pleased to note the AIU's recognition of actions we have taken to ensure appropriate professional scepticism is exercised on audits. The AIU's report recognises our emphasis on audit quality, commenting on the significant resources our firm commits both globally and regionally to the implementation of policies and procedures, particularly in relation to independence compliance and monitoring, risk assessment, audit training and technical communications and the quality monitoring of audit engagements.

The AIU have noted areas for improvement and assessed that two of our audits required significant improvement. We have carefully considered the issues identified and we are taking action to address these, with particular focus on recurring issues, as we continue to strengthen audit quality.

The years ahead will bring changes to the way auditors report to improve the value of audit to stakeholders. We welcome these developments and we will continue to work with the AIU and others to ensure that audit quality and transparency are enhanced.

Yours faithfully

Hywel Ball

Hywel Ball, Managing Partner Assurance, UK & Ireland

Financial Reporting Council
5th Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN
Tel: +44 (0)20 7492 2300
Fax: +44 (0)20 7492 2301
Website: www.frc.org.uk