Financial Reporting Council

May 2015

Ernst & Young LLP

Audit Quality Inspection

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Contents

page

1 Background information and key messages

1.1 Introduction

This report sets out the principal findings arising from the 2014/15 inspection of Ernst & Young LLP ("EY" or "the firm") carried out by the Audit Quality Review team of the Financial Reporting Council ("the FRC"). The inspection was conducted in the period from March to December 2014 (referred to as "the time of our inspection"). We inspect EY annually. 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 16 audit engagements undertaken by the firm, of which one was a further review of an audit reviewed in our last inspection. These related to FTSE 100, FTSE 250, other listed and other major public interest entities, with financial year ends between September 2013 and June 2014. Our reviews were selected on a risk basis, utilising a risk model; each review covered only selected aspects of the relevant audit. The further review included an assessment of the extent to which our previous findings on that audit had been addressed.

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. Our reviews did not cover audit work relating to components undertaken by other firms within or outside firm's international network.

Our review of the firm's policies and procedures supporting audit quality covered aspects of 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 which findings 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 any areas of particular focus in our overall inspection programme for the relevant year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.

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.

We acknowledge the co-operation and assistance received from the partners and staff of EY in the conduct of our 2014/15 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. The UK firm is managed by a UK Board 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 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 27 June 2014, the firm's turnover was £1,868 million, of which £550 million related to the Assurance service line[1]. There was a total of 583 partners, of whom 113 were authorised to sign audit reports, and 61 employees (audit directors) who were authorised to sign audit reports[2].

We estimate that the firm audited 399 UK entities within the scope of independent inspection as at 31 December 2013. Of these entities, our records show that 150 had securities listed on the main market of the London Stock Exchange, including 14 FTSE 100 companies and 41 FTSE 250 companies.

The UK firm audits a number of entities incorporated in Jersey and Guernsey whose securities are traded on a regulated market in the European Economic Area. These audits are inspected by us under separate arrangements agreed with the relevant regulatory bodies in those jurisdictions. The results of these reviews are included in this report. Our records show that, at the time of our inspection, the firm had 45 such audits, including two FTSE 100 companies and five FTSE 250 companies.

EY supplies audit services to local authorities and the NHS (Local Public Audits - LPAs). Whilst we review LPAs undertaken by firms, this is done under separate arrangements agreed with the Audit Commission. The results of these reviews are not included in this report because the LPA inspections fulfil a different purpose to those considered in this report. These reviews of LPAs form part of the Audit Commission's assessment of the quality of contracted-out audits. The Audit Commission publishes its assessment both in overall terms and individually by firm. The most recent report can be found on its website.

[1] As disclosed in the firm's financial statements as at 27 June 2014.

[2] As disclosed in the annual return to the ICAEW as at 31 May 2014.

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 findings relating to the review of individual audits, 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 response to our prior year findings, the firm has taken steps to achieve improvements by increasing resources to focus on audit quality in the second half of 2014. It has emphasised the requirements in the relevant areas through enhanced guidance, training and other communications to the audit practice. While the firm has made some improvements to the monitoring and follow-up of independence matters, we continue to have concerns on certain aspects similar to those raised in the prior year. In addition, issues continued to arise in a number of areas including revenue recognition, group auditing considerations, IT controls and journals testing as set out below. The firm should review the effectiveness of its actions in these areas. We comment further on these areas in section 2.

1.4 Key messages

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

- Monitor action taken to address the deficiencies identified in the firm's independence processes and guidance, and ensure that resources are sufficient to identify and respond in an appropriate and timely manner.
- Take further action to ensure that all partners in the firm are fully aware of, and comply with, the requirements under Ethical Standards and the firm's independence policies and procedures.
- Review the firm's audit methodology and training in light of the continuing issues concerning the audit of revenue (including substantive analytical review procedures and revenue recognition).
- Ensure audit teams pay more attention to the nature and complexity of entities when determining the scope and extent of group and component audit procedures.
- Improve the audit approach in relation to the testing of journals including the selection of journals based on the characteristics of fraud risk.

- Ensure that the firm's auditor's reports accurately describe the audit procedures performed to address the identified risks and include a clear description of the audit scope, coverage and materiality.

2 Principal findings

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

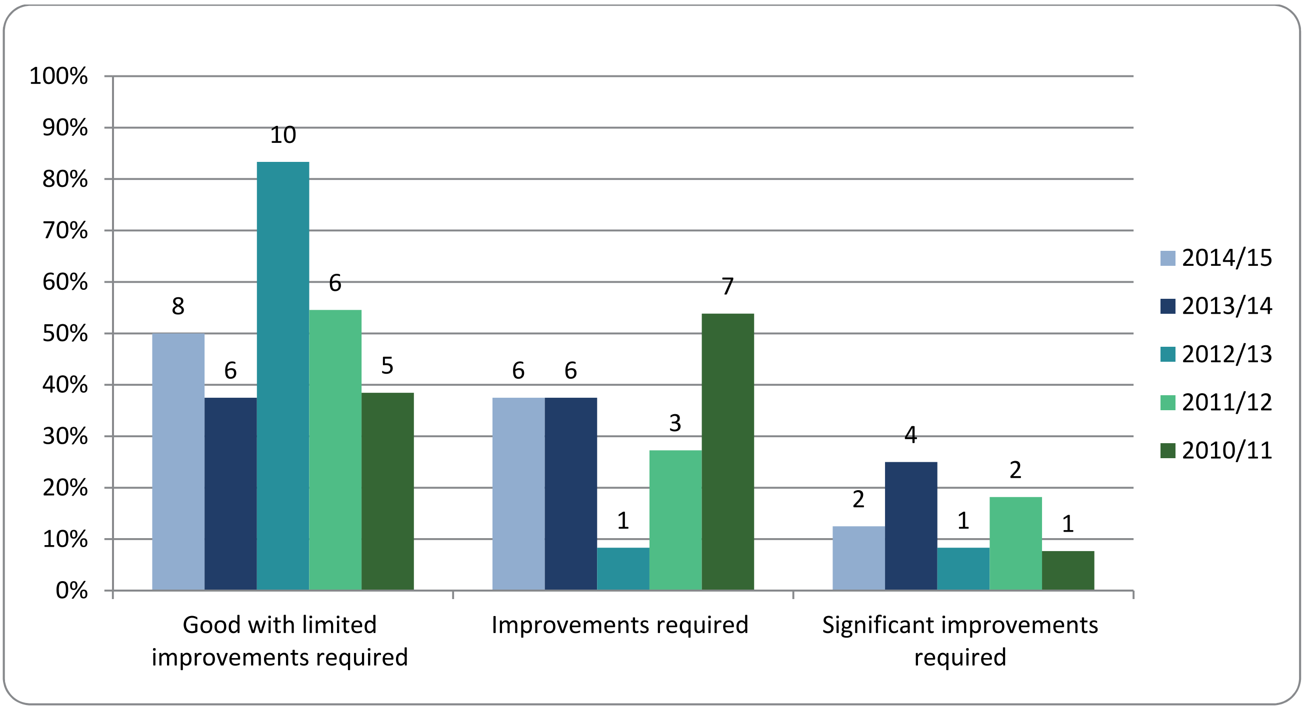
2.1 Reviews of individual audits

We reviewed and assessed the quality of selected aspects of 16 audits (2013/14: 16 audits), of which one (2013/14: none) was a further review of an audit reviewed in our last inspection which included an assessment of how findings previously raised had been addressed.

Eight of the audits we reviewed were performed to a good standard with limited improvements required and six audits required improvements. Two audits required significant improvements. In one of these audits this was in relation to evidence obtained from other group auditors and the quality of the audit work performed and evidenced on certain key judgements. In the other audit we raised concerns principally on the audit of revenue, impairment and journals. Further details are set out later in this section. The firm has confirmed that it has undertaken remedial action, as requested, in both cases.

An audit is assessed as requiring significant improvements if we had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of significant audit judgments in the areas reviewed or the implications of other matters 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 our assessment of the quality of the audits we reviewed in 2014/15 with comparatives for the previous four years. The number of audits within each category is shown at the top of each bar.



Changes to the proportion of audits reviewed 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, movements 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 following findings which the firm should ensure are addressed appropriately in future audits.

The significance of these findings in the context of an individual audit reviewed, and therefore the implications for our assessment of the quality of that audit, will vary. However, whatever the implications for the specific audits reviewed, we nevertheless include the relevant findings in this report if we consider them important in the broader context of improving audit quality at the firm.

Audit of revenue

The audit of revenue was reviewed on 12 audits. We identified issues on three audits. We concluded that one of these audits required significant improvements in all the areas set out below.

Analytical review procedures were frequently used to obtain substantive evidence in the audit of revenue. Weaknesses were identified in the application of substantive analytical procedures in all three audits, including a lack of adequate corroboration of management explanations and a failure to set expectations either at all or with sufficient precision.

On all three audits, insufficient testing was performed in respect of certain revenue streams to assess whether revenue had been recorded in the correct period.

We identified weaknesses in assessing the risks relating to revenue recognition on all three audits. On two of these audits there was insufficient evidence that the risk of fraud in revenue recognition had been appropriately identified and the audit approach in this respect lacked clarity. On the other audit, the basis for the conclusion that certain revenue streams did not give rise to a significant risk (for which there is a rebuttable presumption in Auditing Standards) was unsupported.

In two of the three audits, there was insufficient evidence of testing controls over revenue, where the audit team were relying on the operating effectiveness of these controls, and a lack of substantive testing of certain revenue streams.

Group audit scoping

We reviewed group audit considerations in eight audits. In two audits, the group audits were not appropriately planned and scoped. There was no evidence that the group structure in one case and the nature and complexity of the group in the other had been adequately considered when determining which components were significant by size and should therefore be subject to a full scope audit.

On one of these audits, full scope audits were not performed on three components that exceeded the threshold set, contrary to Auditing Standards. On the same audit, given the significance of the balances not subject to specific audit procedures, it was not appropriate to rely on other less rigorous procedures performed to obtain sufficient and appropriate audit evidence.

On the other audit, there was no evidence that the group audit team had taken certain aspects of significant risks identified into consideration to determine the extent and coverage of the audit work to be undertaken.

Involvement of group auditors

Of the eight audits where we reviewed group audit considerations, we identified issues on four audits, in addition to the group audit scoping issues noted above.

On two audits, for audit work completed by the firm's internal experts that should have been under the direction, supervision and review of the group audit team, it was not appropriate to rely on reviews performed by component audit teams. This work should have been included in the group audit files and been subject to review, as necessary, by the group audit partner and group engagement quality control reviewer.

On two audits, there was insufficient evidence of the group audit team's direction and review of certain aspects of the audit. On one of these audits, a letterbox[3] company, there was insufficient detail of the work performed on the consolidation and the group financial statement disclosures.

Audit of loan loss provisions

We reviewed the audit of loan loss provisions on two audits. We identified issues on one audit.

There was a lack of understanding and review by the audit team of the procedures performed on their behalf by the group audit team and the conclusions reached.

For most key controls over loan loss provisions, the audit team retested items already selected by internal audit and performed no other testing. Furthermore, in a number of instances, controls testing focused on whether management had performed the control rather than testing its underlying operating effectiveness.

We also identified weaknesses in substantive testing including insufficient evidence that balances had been agreed to source systems, failure to identify inconsistencies between the underlying evidence and the conclusions reached and no evidence that the accuracy of certain provision calculations had been tested.

Journals testing

We considered the appropriateness of the audit of journals in all of the audits we reviewed. On six audits, we found that the audit approach to the testing of journals was inappropriate and that insufficient testing was performed as a result.

On five audits, generic risk criteria were used to select journals for testing with insufficient evidence that the fraud risks specific to the audit had been considered. On four of these audits, there was no explanation why the number of journals tested was sufficient. On three of the four audits, insufficient or no corroborative evidence had been obtained for the journals tested.

[3] Letterbox companies are those groups or companies that have little more than a registered office in their country of registration, with management and most activities based elsewhere. In such situations, the auditor is usually based in the country of legal registration, rather than where management is based.

On three audits, there was insufficient evidence why journals with certain characteristics were excluded from being selected and tested.

IT controls testing

We reviewed the audit of IT controls on six audits and identified issues in three cases.

On two of these audits, we identified issues with IT testing performed to ensure the completeness and accuracy of data used in provision models. On two audits, the audit team did not obtain appropriate independent evidence when testing access controls. On one of these audits, the audit team did not perform further testing of IT general controls despite identifying control exceptions during the interim audit.

Impairment

On one audit which required significant improvements, the audit team should have considered whether there was a significant risk in relation to the carrying value of non-current assets, given that other related non-current assets had been impaired, and planned sufficient appropriate procedures to address this risk. In addition, insufficient audit procedures were performed to challenge management's cash flow projections in relation to this assessment of impairment.

Other findings

Auditor's report

UK auditing standards introduced a requirement for extended auditor's reports for listed and certain other entities[4] with effect from September 2013 year ends. The auditor's report is now required to include a description of those assessed risks of material misstatement which had the greatest effect on the audit, an explanation of how the concept of materiality was applied and an overview of the scope of the audit. The firm issued guidance on this area.

All but two of the audits we reviewed were affected by these new requirements. We identified issues in four cases.

On two of the four audits, the scoping section of the auditor's report was liable to misinterpretation as the reported percentages related to the total amounts at the principal locations rather than the balances that were subject to audit procedures.

On two of the four audits, there was no evidence to support statements made in the auditor's report relating to audit procedures performed. On one of these audits, the auditor's report did not explain that materiality was based on an adjusted profit figure.

On one of the four audits, given the magnitude of an identified prior year error, the auditor's report should have provided an understanding of the qualitative factors considered in determining whether the error required disclosure or correction.

Where an extended auditor's report was not required, in one case the auditor's report was issued under incorrect auditing standards as the audit was not conducted in accordance with the standards specified under applicable audit regulations.

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[4] Entities which apply the UK Corporate Governance Code.

Communications with the Audit Committee

We assessed the reporting to the Audit Committee in all of the audits we reviewed. This was generally of a good standard but we identified weaknesses in five audits. In three cases the written reporting provided insufficient detail or inaccurate information to the Audit Committee. For example, on one audit there was no detailed reporting to the Audit Committee on a significant item. In another case, certain misstatements required to be reported to the Audit Committee were omitted.

Independence – non-audit services

We identified issues related to non-audit services in four audits.

On one audit, where non-audit fees were expected to exceed the audit fee for the year, the audit partner did not discuss the matter with the firm's Ethics Partner, as required by Ethical Standards. On the same audit, there were errors in the analysis of audit and non-audit fees within the Annual Report that were not brought to the attention of the Audit Committee.

On two audits, both large and complex groups with significant overseas operations, there was insufficient evidence that the group audit team had consistently followed the non-audit services approval process.

Quality Control procedures

There was insufficient evidence of timely and appropriate involvement of the EQCR in three audits, including review of the planning and the work performed and time recorded for the audit.

On two audits, the firm's internal technical reviewers raised concerns on disclosures and there was no evidence that these had been appropriately addressed by the audit teams.

Auditor Regulatory Sanctions Procedure

One of the audits requiring significant improvement was considered by the FRC's Monitoring Committee under the provisions of the FRC's Auditor Regulatory Sanctions Procedure. Sanctions were determined which are set out on the Auditor Regulatory Sanctions page of the FRC website.[5]

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 development at both a global and regional level; particularly in relation to risk assessment, audit training and technical communications, and monitoring the quality of audit engagements. We discuss the firm's resourcing on independence compliance and monitoring procedures below.

[5] https://www.frc.org.uk/Our-Work/Conduct/Audit-Quality-Review/Auditor-Regulatory-Sanctions-Procedure/Auditor-Regulatory-Sanctions.aspx

Improvements made during the year

The firm has taken a number of actions to address our prior year findings and enhanced its procedures.

The firm has appointed an Audit Quality Board and an Audit Quality Leader to oversee and implement a programme to deliver audit quality at an enhanced level. This includes taking actions in response to the firm's root cause analysis of our prior year findings and oversight of the firm's recently strengthened Audit Quality Support Team. A one day seminar was held in Autumn 2014 for all audit partners to launch the programme. We will consider the effectiveness of these changes in our future inspection cycles.

In response to our focus on letterbox companies in the prior year, the firm significantly enhanced its guidance and training in this area. The firm also held discussions with a number of audit teams responsible for such audits. The firm implemented central monitoring for the conduct of these audits towards the end of 2014 which we will consider in our next inspection cycle.

As in prior years, a list of "hot topics" was issued to all audit staff summarising key areas of focus relating to audit quality for 2014 year end audits. The topics formed part of the firm's response to our prior year findings and covered review procedures, IT audit work, testing of controls and journals, and the assessment of non-audit services. These areas were included as key components of the firm's mandatory classroom training during the year, with supporting technical alerts issued as appropriate.

Prior year findings not adequately addressed

The following prior year findings, noted last year, had not been adequately or fully addressed by the firm at the time of our inspection.

Independence and ethics

Escalation of independence breaches and other matters

In the prior year we noted that there was no formal escalation process for independence breaches or significant matters. A formal escalation process has been introduced for the Ethics Partner and his team to follow if an independence matter is not satisfactorily addressed. This process would be strengthened, however, if it included clearer timeframes, reporting lines and authority levels for individual members of the Independence Team.

Identification of audited entities

We continue to have concerns that the key audit client database is not monitored or maintained with sufficient rigour or frequency, resulting in a risk that prohibited investments and non-audit services for audited entities would not be promptly identified.

IT application controls testing

Last year, we raised an issue concerning inappropriate IT application controls testing by non-IT audit staff. Audit teams were provided with training and reminded to use IT specialists to perform or support IT application controls testing. However, this training was provided in Summer 2014 and hence was not applied in the December 2013 audits we reviewed. Consequently, we identified issues on a number of audits where inexperienced audit staff performed and reviewed IT application controls testing without appropriate consultation with IT specialists. We will therefore consider this further in our next inspection.

Current year findings

In our 2014/15 inspection we identified certain areas where improvements to the firm's policies and procedures are required.

Independence and ethics

At the end of 2014 the firm made a number of changes to its systems and processes in relation to independence monitoring. Our inspection was undertaken prior to most of these changes being implemented. We will review the effect of the changes during our next inspection cycle.

A number of the findings below indicate that the firm may not have sufficient staff in place, with clear roles and responsibilities, to address independence matters. The firm should consider strengthening resources in this area.

Disposal of prohibited investments

Ethical Standards require partners to dispose of any financial interests in audited entities immediately, or as soon as possible, after the relevant person has actual knowledge of, and the right to dispose of, the interest[6]. When individuals are identified as holding prohibited investments by the firm, disposal is required within ten working days. The firm should reconsider this policy in light of the requirements of Ethical Standards.

Notwithstanding the firm's requirement to dispose of shares within ten working days, the Independence Team has discretion to grant extensions related to financial interests held. However, no related guidelines are in place for these extensions and consequently no formal consultation with the Ethics Partner is required. We understand that changes have recently been made to the process for granting extensions and will review these during our next inspection.

Further, the firm does not confirm consistently that the disposal has taken place and that it was on a timely basis. Follow-up emails to the staff concerned are not tailored to reflect the severity of the breach and the required promptness of the individual's action.

The firm requires investments held by partners and staff, together with those held by immediate family members, to be registered promptly on the Global Monitoring System (GMS). GMS does not treat investment entries as valid unless they are entered in full with a correct securities number (ISIN). This has resulted in delays in identifying prohibited investments held by partners and staff.

Personal independence monitoring

Each year the firm carries out an independence confirmation process for all partners and professional staff and tests the accuracy of recorded financial interests for a sample of partners and managers. Any omissions or errors by partners, including those that resulted in a failure to dispose of holdings in prohibited entities, are generally subject to small financial penalties. The findings from the confirmation process and testing are not formally reported to the Board. Whilst an individual's performance manager is informed of the results, the firm does not take this into account as part of the annual performance review given the small financial penalties.

[6] APB Ethical Standard 2, Financial, Business, Employment and Personal Relationships – Paragraph 14.

The firm requires those chosen for testing, as at either 30 June or 30 September, to provide supporting documentation for their investments within ten working days of being informed of their selection. At the time of our review in mid-December, some documentation had still not been provided. Furthermore the firm had not completed all of the testing where documentation had been provided as the testing is planned to meet the firm's internal deadline of the end of March following the testing date.

Financial interests in other partnerships and business arrangements

Partners and staff do not inform the firm consistently about investments in business arrangements (for example, partnerships and other similar business relationships). The firm's communications are not sufficiently clear on when and how such arrangements should be reported.

In one case five partners and one director had not reported their investment in a land partnership with a number of other individuals, many with previous connections to the firm. One of the other individuals recently became a non-executive director of an audited entity which created a prohibited business relationship under the firm's policies. As the land partnership had not been reported to the firm, this relationship was not identified until several months after it occurred.

Escalation and reporting of independence breaches and other matters

Until very recently, there was no central log to formally record and monitor independence matters. As a result, the Ethics Partner and, where appropriate, those in the chain of command were not always informed of, and consulted on, serious independence matters and breaches. A central log was put in place in December 2014 which we will review during our next inspection. .

Approval for audit and non-audit services

The firm uses GTAC (Global Tool Acceptance and Continuance) to ensure that audit and non-audit services are approved by the audit partner before an engagement commences. Audit teams are required to separately search the database of audited entities as it does not automatically interface with GTAC. For 2014 this resulted in numerous instances where audited entities had not been identified and consequently the audit partner's approval was not obtained in advance of providing non-audit services, including nine such cases for listed entities.

In instances where the firm provides services to entities it did not audit and subsequently gains the audit, formal approval of non-audit services remains with the lead client service partner (in a non-audit service line) until the audit commences. This increases the risk that non-audit services approved after the audit is won but prior to the audit commencing undermine the independence of the firm. The approval process should be changed so that the incoming audit partner formally approves all non-audit services. In addition, we identified one instance where the firm gained a new audit and the audit work commenced before the firm's acceptance procedures were fully completed. The processes should be improved.

In some cases the approval for non-audit services is delegated by the audit partner to other individuals. The scale of non-audit fees was the main reason for the delegated authorities. There was insufficient focus on the nature of non-audit services that delegates could approve. Furthermore the scope and extent of the delegation of authorities were not formally recorded or approved. This increases the risk that inappropriate non-audit services might be approved without the audit partner's knowledge.

We noted two instances where engagement continuance forms were approved after audit work had commenced. In one case, the approval was given by a component audit partner. The firm should not allow audit work for the next financial year to commence until the audit engagement partner has re-considered the firm's independence and decided that it is appropriate for the firm to continue to act as auditor.

Audit Quality Monitoring (AQM)

The firm's audit quality monitoring is undertaken as a global and regional network exercise. In 2014, nearly all of audit engagement reviewers were from overseas network firms. We consider that the high level of non-local reviewers significantly enhances the independence of the review and enables best practice to be shared across network firms.

Evidence for conclusions

In a number of cases reviewers had not recorded the basis for their conclusions on specific findings arising in reviews and had not justified why mitigating factors presented by audit teams were considered to be appropriate. Furthermore, the reason for the overall grading of a review was not explicit as the final conclusions were generic and not tailored to reflect the relevant findings.

Assessment of adequacy of EQCR

Engagement quality control reviewers are appointed on certain engagements. AQM reviewers are asked to consider the sufficiency and appropriateness of the involvement of the EQCR. However, the EQCR's performance appraisal does not reflect the findings, even if his or her involvement is deemed to be less than satisfactory.

Review of firmwide procedures

In 2014 the firm reinstated an annual review to monitor firm-wide quality control procedures to comply with Audit Regulations, in response to a finding in our prior year report. This does not include independent monitoring of a number of key policies and procedures including certain aspects of independence, fit and proper confirmations and professional indemnity insurance.

Review of component entities

Selection of UK subsidiaries within the AQM programme is at the discretion of the UK and regional coordinators. The group file should contain sufficient audit documentation to assess the group audit team's involvement in significant components and their evaluation and review of key working papers. However issues relating to the quality of the audit work performed on subsidiaries may only be evident through review of the component audit team files.

Use of offshore centres

The firm continues to use offshore centres based in India. Offshore staff are assigned to, and work as an extension of, an audit team. The firm's use of offshore centres as a percentage of total audit hours was approximately 6%. UK audit teams are unaware of offshore staff performance ratings and capabilities. Offshore staff receive mandated global training but this does not include UK-specific modules.

The firm's methodology and guidance limit the work that can be performed offshore to objective procedures that require little or no judgment. There are therefore no specific prohibitions on offshore procedures and the work allocated to offshore centres is at the audit teams' discretion. The firm's examples of audit procedures for offshore staff are not intended to be exhaustive and it does not expect the example procedures to be appropriate for all audit teams. In most areas, the firm does not have standard work programmes which can be used to restrict the work performed by offshore staff.

There is no central oversight or monitoring of the nature of the work that is performed by offshore staff. The firm also allows review of offshore work to be undertaken by more senior offshore staff in certain circumstances. A second review should always be performed by a member of the core UK team.

The AQM review does not separately consider offshore work included in audit files.

Audit tenders

There has been a significant increase in tender activity in the current year. The firm has committed considerable resources and time to participating in tender bids. We reviewed a sample of four tender documents. In respect of the tenders reviewed, the documents included certain statements that could confuse the reader or be misinterpreted.

The documentation supporting a bid for a listed entity stated the benefits of including the firm's head of technical accounting on the core audit team. However, no reference was made to any compensating processes put in place to ensure that the level of independent challenge provided by the technical accounting group would not be compromised.

Other matters

Banking thematic review

In December 2013 the FRC announced that during 2014 it would perform a thematic review of the quality of bank and building society audits, focusing on the audit of loan loss provisions and related IT controls. The thematic review sought to identify why progress in improving audit quality in these areas had been slow and what further action was needed to achieve the necessary improvements.

As part of the thematic review, we reviewed the policies and procedures applied by the firm in conducting bank and building society audits. The firm does not have procedures in place to ensure that all banking audit personnel attend all relevant industry training courses and should take appropriate action to address this weakness.

The FRC published a report in December 2014 setting out the principal findings of the thematic review and identifying key messages arising for both auditors and audit committees.

Transparency report

We reviewed the firm's transparency report for the year to 30 June 2014, which was published in September 2014, 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 inconsistencies with our understanding of the firm's quality control and independence procedures.

In common with certain other major audit firms, the transparency report was enhanced to identify factors which contribute to audit quality. The firm included a number of audit quality metrics in the report on professional disciplinary history, internal quality reviews, training investment and interaction with investors. We believe this is a positive development.

Andrew Jones

Director

Audit Quality Review

FRC Conduct Division

29 May 2015

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 supporting audit quality 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 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 our 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 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 our public report on each inspection, taking into account their relative significance in relation to audit quality, in the context of both the individual inspection and any areas of particular focus in our overall inspection programme for the year. Where appropriate, we have commented on themes arising or issues of a similar nature identified across more than one audit.

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 rigorous quality control procedures are applied. These procedures include a peer review process at staff level and a final review by independent non-executives who approve the issue of all reports. These processes are designed to ensure both a high quality of reporting and that a consistent approach is adopted across all inspections.

We also issue confidential reports on individual audits reviewed during an inspection. While these reports are addressed to the relevant audit engagement partner or director, they are copied to the chair of the relevant entity's audit committee (or equivalent body).

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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13 May 2015

Dear Mr Jones

FRC Public Report on the 2014/15 Inspection of Ernst & Young LLP

We welcome the opportunity to respond to the FRC's report. We share with the FRC a common objective of promoting confidence in UK capital markets by a continuous focus on audit quality. Ensuring that we deliver high quality audits is fundamental to our business and our public service obligation. This is a responsibility we take very seriously; we continue to invest in our business to enhance our audit quality and have increased this investment during the last year.

As the FRC's public report shows, there has been an increase in the number of EY audits inspected achieving the higher rating of *Good with limited improvements required*. Following our own review of our audit practice and the publication of the May 2014 FRC Public Report, we established a long term audit quality programme which we outlined in our UK Transparency Report 2014 (published September 2014). This programme is wide reaching and considers all aspects of our firm that have an impact on audit quality. We are pleased that the FRC has recognised the steps EY has already taken to improve audit quality and the considerable emphasis we place on our systems of quality control. The majority of the actions below were taken after the completion of the audits reviewed in the 2014/15 inspection (which comprised audits with financial year ends between September 2013 and June 2014) and so were not reflected in this year's report. We expect the impact of these actions will be reflected in the FRC's 2016 Public Report.

As part of the programme, we have taken the following actions:

- We appointed an Audit Quality Board that provides oversight of and takes actions to implement the audit quality programme.

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- We held an Audit Quality Summit for all UK audit partners and we continue to engage with them and the wider UK audit practice in relation to the changes and improvements being implemented.
- We appointed an Audit Quality Leader (a senior EY audit partner) who makes recommendations and requests changes in governance and control of the audit practice, as deemed necessary.
- The Audit Quality Leader also leads our new Audit Quality Support Team (AQST). The AQST performs in depth reviews of selected engagements during the audit process.

We also recognise that maintaining our independence is fundamental to confidence in the quality of our audits. We are increasing the size of our independence function and strengthening our practices.

We thank the FRC for their work and value the independent perspective they provide.

Yours sincerely

Hywel Ball
UK Head of Audit

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