Transparency Report 2014

EY UK – Volume 1

EY

Building a better working world

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Volume 2

Volume 2 provides further detail on matters like our legal and governance arrangements, our commitment to quality, independence practices, financial information and our work with our stakeholders and communities. It can also be accessed online here. Volumes 1 and 2 combined address our obligations under the European Union's 8th Company Law Directive and the Statutory Auditors (Transparency) Instrument 2008.

More information about EY can be found at ey.com

A foreword from our Assurance Leadership

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Welcome to the 2014 EY Transparency Report.

Compiling this report to meet our statutory obligations as auditors of public interest entities brings a welcome opportunity to set out EY's commitment to professionalism, independence and delivery of high quality audits.

Having taken soundings from our stakeholders, we have restructured our report this year to better reflect the issues important to you. Here in Volume 1, we provide an account of our audit performance and describe how changes in audit governance and corporate reporting are driving enhanced value to capital markets. Volume 2 covers the legal and governance framework of the UK firm and how we operate within the wider framework of our global organization. We also provide information there on our investment in audit processes and technology and describe how we work with stakeholders and our communities.

Our global purpose, as part of our Vision 2020 strategy, is to 'Build a Better Working World'. In our Assurance practice, we do that by constantly challenging our partners and people to commit to exacting standards.

We welcome your feedback. Over the year, we will be providing opportunities for you to comment on the issues we raise within the Transparency Report at our regular meetings with audit committees, investors, regulators and other stakeholders. You can also contact us direct at UKProfessionalPractce-GB@uk.ey.com. We hope you find the report interesting and that you will continue to engage with us.

Market Developments

The development of our firm

Over the last financial year to 27 June 2014, the UK firm grew its total revenues to £1.868 billion, an increase of 9% on the previous year's £1.721 billion. Assurance revenues account for 30% of the firm at £550m with statutory audit fees of £341m, compared to £507m and £333m for 2013. A more detailed breakdown of our revenue can be found in Volume 2, page 29.

The UK audit market

As at 27 June EY audited 17 FTSE 100 companies (compared to 15 in 2013). EY UK audit 15 of those 17 and 2 are audited by other EY firms. In the last six months we have participated in eight FTSE 100 audit tenders, of which we won two. We also declined to participate in a major FTSE 100 tender where we believed we could not satisfy independence requirements before the appointment. The market for new mandates remains fiercely competitive, and companies continue to make discerning choices during audit tenders. We typically find buyers are prioritising audit quality over price in the choices they make, in spite of a continued pressure on fees. We are seeing a degree of innovation in the buying process, and we expect this to accelerate as the implications of the forthcoming EU Audit Directive and Regulation and the Competition and Markets Authority Order under the Enterprise Act are evaluated and addressed.

We are finding that more sophisticated buyers are seeking to reduce the cost by running shorter tenders and by providing more comprehensive data, resulting in fewer management team meetings. It has become more commonplace for audit committees to confirm independence prior to starting the process. This is important given the restrictions companies face in choosing non-audit service providers while the tender process is running. Companies are also interested in innovation from audit firms including the capacity to interrogate complete data sets and to offer more forward-looking assessments of risk.

The UK firm will begin rolling out its own new audit support tools next year, which will benefit client companies. Globally, EY is investing $400m on audit innovation.

Our listed company audits are generally our most technically complex. We deploy the same skills and experience when we work with the middle market and entrepreneurial businesses that have long been a part of our Assurance portfolio and that play such a central role in the economic wellbeing of the UK.

Overall, we are seeing increased demand for assurance services, which provide confidence to business and its stakeholders, not only through the statutory audit, but also in non-audit assurance services to companies whether or not we are the auditor. These non-audit assurance services have experienced double-digit growth in the past two years.

We see a broad assurance portfolio of services as vital to ensure the overall personal and technical development of our external audit professionals.

EY's investment in recruiting and developing first class professionals will always be the cornerstone of our success. Our Assurance personnel have grown by nine per cent to 3,045 professionals and we have also welcomed seven new Assurance partners in the UK during the year to 27 June 2014.

It continues to be our priority to increase our share in the UK audit market and to recruit and develop high quality individuals who will enable us to do so.

Audit and non-audit services

Over the next two years, the UK government and the Financial Reporting Council will implement European legislation concerning the appointment of auditors and the services that listed companies may purchase from their auditor.

There are many uncertainties about implementation, but it is clear that this will, in due course, disrupt the current arrangements of many companies.

We are already seeing companies respond. There have been cases where companies have not been able to involve all the firms they would have wished to involve in a tender because of the non-audit services provided by those firms. To enable maximum choice at a tender, we believe each company should have a clear strategy setting out the services they are likely to require and from whom, if they are to address the independence restrictions that external auditors face and the capacity limitations that audit firms will likely experience.

We understand these changes bring challenges for companies in the short term. Overall, we believe they represent an exciting evolution and we are competing hard to strengthen our Audit practice and investing significant resources to accomplish that. However, we will not seek appointment if we are not satisfied that we can deliver a high quality audit.

The risk environment

The climate for business in the UK continues to provide challenges across a number of fronts.

Certain inherent risks are changing in their profile and these include:

- Retention – as confidence returns, talented individuals may become more ready to look at new opportunities, making it more important for businesses to evaluate the likelihood of losing staff to competitors
- Cyber security – the risk to UK plc from hackers backed by organised crime syndicates is causing mounting concern and requires an appropriate response
- Political risk – increasing political instability worldwide is among one of the most significant risks business leaders face
- Natural resources – corporates face a stark decline in external resources that were once considered to be abundant
- Corporate culture – slight changes in the intensity of corporate culture can result in a successful company becoming a casualty. This is not confined to financial services companies

These risks will typically form part of our audit planning work.

Emerging financial reporting considerations

Financial reporting requirements under IFRS are complex and continue to present challenges for companies. At the same time, all the companies we work with are being encouraged by regulators and other stakeholders to make their financial reports clearer and more concise, while being fair and understandable.

The main new IFRS requirements for most of our clients this year are the new consolidation standards, IFRSs 10, 11 and 12. Meanwhile, there are a number of areas that continue to be a focus for our audit teams and for regulators, in particular:

- Revenue recognition, including the risk that policies do not keep pace with new business activities and changes in customer relationships/contracts and adequacy of policy disclosures
- Business combinations, including identification of intangible assets, valuation of non-cash consideration and accounting for contingent payments to vendors
- Impairment of assets such as goodwill, including disclosure of assumptions and sensitivities

IFRS 15 Revenue and IFRS 9 Financial Instruments do not need to be mandatorily adopted until 2017 and 2018, respectively, but they will present major challenges for some companies.

The new UK GAAP becomes mandatorily applicable from 1 January 2015. All companies will need to consider carefully its application to them and this will be an important area of audit focus over the next 18 months.

Our audit quality performance

Ensuring that we deliver high quality audits is fundamental to our business and our public service obligation. In conjunction with the other major audit firms, we have worked to produce a set of Audit Quality Indicators (AQIs) that identify and measure factors contributing to audit quality. The biggest firms will adopt these measures voluntarily so that buyers of audit and assurance can benchmark audit performance and make comparisons across the firms.

Providing an agreed measure of quality in audit is necessarily a complex task. We have agreed a set of metrics that range across survey-based information from staff and partner comments on their resources, to measures from external inspections and engagement performance reviews, to information about firms' investment in the audit process and their investor liaison. It is our hope that these measures will provide a meaningful contribution to the audit procurement process and ultimately help to enhance the integrity of the corporate reporting system.

Professional disciplinary history

Our firm is regulated and subject to professional disciplinary action in cases of potential misconduct. The Financial Reporting Council (FRC) deals with cases that appear to raise important issues affecting the public interest in the UK. Other disciplinary matters are addressed by the Institute of Chartered Accountants in England and Wales (ICAEW), our Recognised Supervisory Body.

During the year to 27 June 2014, we received a reprimand and were fined £750,000 by the FRC's Conduct Committee in relation to our audit of the 2005 accounts of Farepak Food and Gifts Ltd. We admitted that our conduct of the audit fell below the standards to be expected of ICAEW Members and Member Firms, as we failed to comply with requirements of applicable auditing standards. We were disappointed in the quality of the audit we performed in this case and in the eight years since that audit was undertaken we have taken action to address the issues identified in this case.

The FRC conducted an investigation during the year into whether or not ethical standards had been breached by a former partner in relation to the non-timely disposal of a financial interest in a client of the Firm and has recently announced that no further action is to be taken. At the time of writing we remain subject to investigation by the FRC in relation to our conduct in relation to the audits of Computer 2000 Distribution Ltd. We are also subject to investigation by ICAEW in relation to an insolvency appointment.

The ICAEW has not found against the firm in relation to any matter during the year to 27 June 2014.

Internal quality reviews

A fuller description of our Audit Quality Review (AQR) programme is set out in Volume 2 of the Transparency Report on page 21.

Each year we undertake a review of a sample of audit engagements. The review is conducted in the summer months and inspects audits performed in the previous year – so audits reviewed in the summer 2014 are primarily from audits of December 2013 accounts.

This review is performed by EY professionals based in offices other than that in which the audit in question was undertaken. It is subject to the oversight of senior partners from our Global organisation to ensure the rigour, integrity and consistency of the review process.

Our review process is intended to cover every Responsible Individual (partners and directors authorised to sign audit reports) at least every three years and every FTSE 350 audit every six years. Other audits are selected for review cover a cross section of the Audit practice. However, greater weight is given to selecting engagements with certain risk characteristics. The percentage of RIs reviewed in each of the last three years was: 32% in 2014; 34% in 2013; and 40% in 2012.

We evaluate the results of our review on a three-point scale:

1 = no or minor findings
2 = findings that were more than minor but less than material
3 = material findings

The results of recent reviews are as follows:

	2014 Review	%	2013 Review	%
1	45	73	59	73
2	15	24	20	25
3	2	3	2	2
Total	**62**	**100**	**81**	**100**

The reduction in reviews conducted in 2014 is in part a reflection of the smaller proportion of RIs required to be reviewed this year and we anticipate that the number of engagements reviewed will increase again in 2015.

For audits with material findings, the firm determines and implements a remedial action plan. A quality improvement plan is also developed for each office subject to review. We communicate lessons learned from the reviews to our Audit practice and include them in future training. The results of AQR play an important part in our assessment of partner and staff quality, which is in turn a key input into individuals' promotion and reward. This is described further in Volume 2 under partner remuneration (see page 31).

External inspections of the firm

The firm is subject to external inspection by the FRC's Audit Quality Review Team (AQRT), the ICAEW's Quality Assurance Department (QAD) and the Public Company Accounting and Oversight Board (PCAOB) in the US.

The AQRT published its public report on the firm in May 2014. The bulk of the AQRT's inspection work was performed in 2013, however, and reflects findings in relation to audits from earlier financial periods.

The last QAD inspection took place in 2013 and their report was issued in Spring 2014. QAD noted that: 'The firm has generally maintained a high standard of audit work on the files reviewed'. Nine of the 10 files reviewed were rated as 'Satisfactory' or 'Generally acceptable but a small number of improvements required' (the two highest ratings). One engagement was rated 'Significant improvements required' in relation to audit considerations on transition to IFRS. We have taken action to address the matters identified by QAD.

The PCAOB inspects the firm every three years and its public report on its 2011 inspection was published in September 2013. The report identified improvements needed on two 2010 audits. The PCAOB has, at the time of writing, just started its 2014 inspection of the firm and we will report on that in next year's Transparency Report.

The AQRT rates audits on a four point scale: 1, 2A, 2B and 3. In its public reports on the firm, it combines 1 and 2As as 'Good with limited improvements required'. A 2B is reported as 'Improvements required', while 3s are reported as 'Significant improvements required'.

The 2014 AQRT report highlighted the following results:

	2014 Report	2013 Report	2012 Report
Good with limited improvements required	6	10	6
Improvements required	6	1	3
Significant improvements required	4	1	2

We were disappointed by the results included in the 2014 report, particularly given the improvement in results highlighted in the previous report. However, the FRC's report pointed out that the change in gradings was not necessarily indicative of any overall change in audit quality at the firm. We nevertheless took steps to address those specific findings that had a major impact on our gradings this year.

We have also established a long term audit quality programme. The objective of this programme is to deliver audit quality at an enhanced level, as we believe our stakeholders will increasingly demand higher standards. As part of the programme we have taken the following actions:

- We have appointed an Audit Quality Board that will provide oversight of and take actions to implement the audit quality change programme
- We held a full day Audit Quality Summit for all UK audit partners and received full support for a programme to deliver market leading quality
- We have appointed an Audit Quality Leader (one of our experienced bank auditors) who will make recommendations and request change in governance and control of the Audit practice as he deems necessary
- We are communicating short term actions to our Audit practice in September, with longer term actions to be communicated by the end of November 2014

The Audit Quality Leader will also lead our new Audit Quality Support Team (AQST). The AQST will perform in depth reviews of selected engagements during the audit process. The AQST will have the authority to effect changes in audit team composition and audit procedures as they deem necessary.

During the year, the FRC also conducted thematic reviews into 'Materiality' and 'Fraud and Laws and Regulations'. Over the course of these thematic reviews, the FRC focuses on specific aspects of the audit process across all the major audit firms. We have met with the FRC to discuss the implications of their findings for EY, have reflected the results of these reviews in our 2014 training and have taken actions to increase the involvement of our fraud specialists within our audits.

The FRC is currently in the process of conducting two further thematic reviews, one into smaller company reporting and one into bank audits. We will respond to these findings as they are published and will report on them in next year's Transparency Report.

Investing in our audits

We continue to make significant investments in our ability to undertake high quality audits. One component of that investment is training. In the last two calendar years we delivered the following mandatory structured training hours to our teams, which principally relate to audit and financial reporting training.

	2013	2012
Senior 2	61	60
Senior 3	47	39
Manager	26	25
Senior Manager	26	25
Director/Partner	26	25

As well as mandatory structured training, staff and partners undertake personal training and development specific to their needs. Staff involved in PCAOB audits undertake further specific training on those standards for instance. We also set minimum continuing professional development (CPD) requirements for all partners and staff, discussed further on page 27 of Volume 2.

At EY we recognise that listening to feedback from our people as to their thoughts and concerns is essential if we are to gain a fuller understanding of our ability to deliver high quality audits. Full global people surveys are undertaken every two years, with a shorter pulse taking survey in the intervening years.

Future Transparency Reports will include responses to the following questions:

- My firm places sufficient emphasis on audit quality
- I have sufficient time and resource to deliver quality audits
- I receive enough training and development to enable me to deliver quality audits

The next full global survey, which will incorporate questions on the topics referred to above, will take place in Spring 2015.

Interaction with investors

This year, EY launched a Dialogue with Investors programme to establish a more meaningful and lasting exchange between the firm and leading institutional investors. Our interactive events are designed to provide greater insight on how we fulfil our public interest role. We also want to help equip investors to engage with investee companies on reporting and auditing matters and provide an opportunity to debate key business risks with this important stakeholder group.

We place a high premium on clear communication with investors to make sure we understand, and can articulate, their views on corporate governance, corporate reporting, audit, assurance and other capital market issues. We do this through meetings with individual organisations, conversations with trade bodies and other groups, as well as at EY events. For more details on how this is working with our stakeholders and communities, please see page 32 in Volume 2.

Delivering value to Capital Markets

We are very conscious that much of what we do during our audit process and the value it delivers is not visible to many of our stakeholders. We continue to try to find ways to address this issue.

Investors tell us corporate reporting is important to them and 2013 saw far-reaching changes within UK corporate reporting practice. Annual Reports and Accounts (ARA) of listed companies now include a Strategic Report, enhanced Audit Committee and auditor reports, a board statement that the entire ARA is fair, balanced and understandable, and expanded reports on executive remuneration. During 2014, we reviewed a large sample of FTSE 350 reports to assess how the changes have been implemented, to identify emerging practices and themes and suggest areas where companies might improve.

Companies applying the UK Corporate Governance Code must now include an expanded audit report. Our auditors have welcomed the opportunity to provide greater insights into major audit risks and how we respond, along with our approach to setting audit scope and how we have considered materiality in our audit process. We are now reviewing the results of the first year's experience and will be revising our guidance so as to further enhance the value of our report.

The expanded audit report complements the enhanced reporting obligations of Audit Committees also introduced by the FRC. We believe that strengthening the Audit Committee role and auditor reporting has brought real value to stakeholders

We have also sought through our engagement sessions with institutional shareholders during the year to explain our audit process in greater detail. We want to ensure we communicate on how we address complex issues and explain how we responded to the FRC's recent thematic reports. Investors who attended tell us that they value these opportunities for debate and derive insights from them.

Investors were particularly interested in 'getting under the bonnet' of an audit and gaining an understanding about how audit judgements are reached and then discussed and resolved with management and Audit Committees.

Audit Committees have new reporting obligations on audit effectiveness and a new imperative to rotate audit firms regularly, measures that raise questions as to how audit effectiveness can be assessed. We have produced guidance which aims to give an account of what audit quality means for Audit Committees and shareholders and how it can be assessed.

Our governance

Volume 2 describes our legal structure, ownership and governance in some detail. However we highlight certain aspects that we think are important to our stakeholders.

Oversight

EY is unique amongst all the large audit firms in its governance arrangements. Through the process of global integration completed several years ago, our UK Board and management (the UK team) is subject to oversight from higher levels of Area and Global leadership. The UK team is subject to regular review of its actions and its performance across all areas of business activity and benchmarked relative to comparable firms elsewhere in the world. Whilst decision making is primarily local, the regular review process provides another level of informed challenge to intended decisions and plans. And to reinforce the importance of engaging with the challenges that are made, the remuneration of the UK team requires concurrence at an Area level.

This approach applies to all our service lines, but there are particular features that apply to the Audit practice. For instance:

- Certain kinds of decisions on audit engagements require prior approval at an Area or Global level so that we obtain globally consistent outcomes where the fact patterns are the same
- The audit engagements that are selected for our internal quality inspections are approved at an Area level so as to avoid an inappropriate population being selected
- Our UK Audit Independence team is accountable to Global Independence Leadership and its decisions are subject to their review, as appropriate

Report from Independent Non Executive

Sir Richard Lambert - on behalf of the EY INEs

EY first appointed independent non-executives (INEs) to its Global Advisory Council during the course of 2011. As we move into our second three-year term, this is a moment to reflect both on the impact of these appointments, and on how the role should be developed in the future.

The appointments were triggered by the publication by the Financial Reporting Council of the UK Audit Firm Governance Code. The work of the INEs is intended to reinforce public confidence in the public interest aspect of the firm's decision-making process, to encourage its dealings with a wide range of stakeholders, and to help ensure the appropriate management of reputational risks. As a global organisation, EY took the decision to appoint its INEs at a worldwide level, rather than to focus their activities solely on the UK practice.

This has the advantage of giving us INEs a good understanding of the risks and opportunities facing the firm around the world, as well as direct and regular access to its most senior leaders. Such a perspective has been particularly relevant during a three-year period that has seen the development of the very ambitious Vision 2020 strategy. An important role of the INEs has been to ensure that the public interest has been kept front and centre of the firm's strategic planning process.

As part of this exercise, a Governance Working Group was set up on which I sat. Its aim was to bring the firm's governance practices into line with the demands of Vision 2020, and its recommendations will be put to the partners in the coming months. With their approval, the aim is to go live in the summer of 2015.

One recommendation from this group is to establish a Public Interest Sub-Committee to take account among other things of the public interest aspects of decision-making and stakeholder dialogue, as well as of issues raised under whistleblowing and other procedures. This committee will include all the INEs. The task of the coming months will be to define its mandate and lines of accountability, and to come up with a body that can have an impact both at a local level and more generally on the workings of a very large global organisation.

The past three years have been a time of rapid regulatory change around the world, and of increasing competition among the big firms as audit rotations increase in frequency. These are, of course, matters of deep interest to us INEs. We believe that EY has responded in an appropriate way to these changes: engaging with the regulators in a professional manner and challenging their proposals in a constructive manner when appropriate, and keeping a rigorous approach to audit quality as the prime consideration in bidding for new business.

Although our attention is necessarily focused on the audit function, other aspects of the firm's business also shape public perceptions of its reputation, and through that its long term wellbeing. One example of this is tax planning, which became a particularly contentious issue in parts of Europe over the past year. Another is the risks that can emerge in firms with a very large and diverse global network of businesses.

During the course of the three years, we INEs have got to know and work well with each other, and we will need to develop further lines of communications in order to fulfil our new responsibilities on the Public Interest Sub-Committee. Our ability to challenge and to bring different ideas to the table has increased as we have got to know the firm better, and as our role has been better understood by our colleagues. We do not see ourselves as playing the part of conventional non-executive directors of a company: instead, our job is to have an insider's understanding of the workings of the partnership, but an outsider's understanding of how its decisions might impact on the wider public interest.

We have been grateful for the way we have been welcomed by our colleagues on the Global Advisory Council, who trusted us again this year with managing the election of the global presiding partner. And we are confident that the firm's leadership takes our views seriously, and responds in a timely way to the questions and challenges we raise.

We are ourselves a diverse group: Shymala Gopinath from India, Klaus Mangold from Germany, Mark Olson from the US, and myself from the UK. To our regret, our colleague Lim Hwee Hua from Singapore decided to step down this year after three years of great service on taking up a new assignment in Singapore, and we look forward to welcoming her successor in due course.

In addition to the global role, I have specific responsibilities for the UK under the Audit Firm Governance Code. The Financial Reporting Council holds me to account for the public interest aspects of the UK firm's performance, and I engage with it both in meetings along with INEs from the other big firms and, when appropriate, on a one-to-one basis.

In order to fulfil this role, I am in regular dialogue with the EY's UK leadership, and twice a year get a full briefing on the firm's domestic operations, with a special focus on audit matters. I expect to be, and am, consulted by EY's leadership on issues that might have a bearing on the public interest, and I welcome opportunities to engage with investors, corporates, and other stakeholders.

An issue of particular importance in recent months has been the firm's performance in the FRC's Audit Quality Review, which was particularly disappointing and surprising given that the outcome of the previous year's inspection had been exceptionally good. I have discussed the reasons for this change with EY's leadership and with the FRC's inspectors, and will continue in dialogue with both these groups on this matter in the coming months.

I am satisfied that EY has responded in an appropriate way to the Audit Quality Review, and has devoted considerable resources both to analysing the causes of the outcome and developing remediation plans. The full results of planned changes will not show through for some time, not least because of the time lag between audit completions and the publication of Audit Quality Review inspections. But EY is clear that audit quality is at the heart of everything it does, and I am completely confident of its ability and determination to meet this challenge.

At a global level, the priority for us INEs in the coming year must be to help lay solid foundations for the development of an effective Public Interest Sub-Committee, and to bring our perspective and judgment to the detailed implementation of Vision 2020 as it unfolds.

In the UK, the prime aim will be to encourage the firm in its determined efforts to return to the top of the audit quality review table, so that it can continue to expand its practice in a well-balanced and sustainable fashion.

I look forward to reporting progress on all these fronts in 12 months' time.

Conclusion

We hope that Volume 1 has provided helpful insights on how EY performs its public interest role. In Volume 2, you can learn about the recurring aspects of our account to you. Volume 2 provides further detail on matters like our legal and governance arrangements, our commitment to quality, independence practices, financial information and our work with our stakeholders and communities. It can also be accessed online here. Volumes 1 and 2 combined address our obligations under the European Union's 8th Company Law Directive and the Statutory Auditors (Transparency) Instrument 2008.

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About EY

EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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