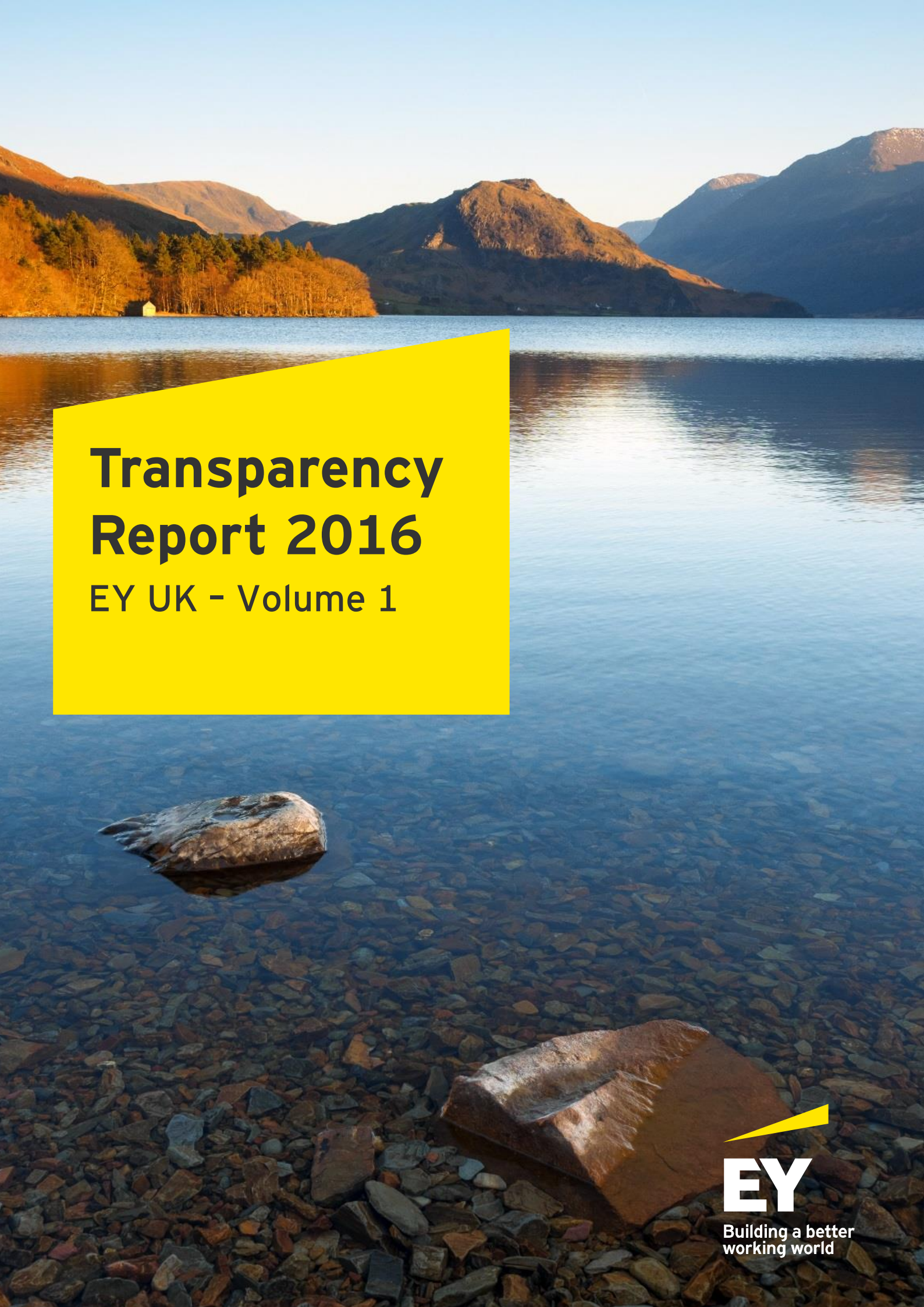
Transparency Report 2016

EY UK - Volume 1



EY

Building a better working world

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Chairman's welcome

Welcome to the 2016 Transparency Report of Ernst & Young LLP (EY UK).

We appreciate that our stakeholders want to understand how we advance audit quality, manage risk and maintain our independence as auditors. This report is one of the ways in which we share with our stakeholders what we are doing in each of these areas. Regular dialogue is important to us and we welcome the opportunity to engage with our stakeholders on a range of matters.

Executing high quality audits continues to be our number one priority. It is at the heart of our ability to serve the public interest and contribute to growing the global EY network successfully and responsibly, while achieving EY's purpose of building a better working world.

Auditors play a vital role in the functioning of capital markets by promoting transparency and supporting investor confidence. Companies, regulators and other stakeholders count on us to deliver excellence in every engagement.

EY is focused on investing in tools to improve what its member firms do, creating the highest-performing teams and building trust and confidence in the audits they perform. EY's reputation is based on, and grounded in, providing high-quality, professional audit services objectively and ethically to every company we audit.

We continue to embrace the transparency objectives of the Statutory Auditors (Transparency) Instrument 2008, which requires UK statutory auditors of public interest entities to publish annual transparency reports, and the Audit Firm Governance Code (the Code).

In July 2016, the Financial Reporting Council (FRC) published a revised 2016 Code, which embeds and has a sharper focus on audit quality, good governance, culture, enhanced transparency and an improved dialogue with investors. For UK member firms of global organisations such as EY, the Code will require, among other things, transparency on how the management and oversight of audit is undertaken and how the Code's purpose is achieved in the UK.

We welcome and support, in particular, the FRC's continuance of the high-level, principles-based approach to the Code. Given the differences between the firms, we concur with the FRC that it is essential that the Code remains "sufficiently flexible to allow firms to apply it in ways which best suit their governance structure." We comment further on our governance structure at the end of this report and in Volume 2.

The revised Code is applicable for financial years beginning on or after 1 September 2016. Although it will not apply to EY UK until FY2018, we hope to have substantially implemented its provisions in FY2017. In particular, I look forward to sharing with you news of the appointment of EY's third Independent Non-Executive from the UK who will further enhance the oversight of our public interest responsibilities.

This 2016 EY UK Transparency Report complies with the European Union's 8th Company Law Directive and covers our financial year from 4 July 2015 to 1 July 2016 (FY2016). The EU UK Transparency Report is broken into two Volumes. In Volume 1 you will hear from the Independent Non-Executives and find out about our views on the UK audit market, our audit quality journey, what our people tell us, how we engage with investors, and about our investment in our people.

In Volume 2, you can learn more about our global network, our internal quality control system, how we instil professional values, how we perform an audit, our review and consultation processes, our approach to audit quality reviews and our independence practices.

EY UK is focused on enhancing audit quality and maintaining our independence. Continuously improving audit quality requires us to challenge approaches to audit execution, and we focus on this by evaluating all inspection findings and taking responsive actions.

I encourage all of our stakeholders – including investors, audit committee members, companies and regulators – to continue to engage with us on our strategy as well as on any of the matters covered in this report.

Steve Varley
Chairman
Ernst & Young LLP

A foreword from the UK Head of Audit

We share with the Financial Reporting Council (FRC) a common objective of promoting confidence in the capital markets by a continuous focus on audit quality. This is why we continue to invest in developing and supporting our audit teams, so we can be certain of sustaining trust and confidence in the audits we conduct. In 2014 we initiated a long-term Audit Quality Programme to help us deliver outstanding audit quality on a sustainable basis. In each of the last three years we have increased our investment in the programme. It is aligned with the EY Global Sustainably Audit Quality (SAQ) programme which was launched in 2015.

The governance of our SAQ programme is achieved through the Audit Quality Board, the performance of which is monitored by the EY UK board. The Audit Quality Board is made up of the major EY UK audit business leaders, our risk management and training leaders and our audit quality leaders. It is chaired by me as the EY UK Head of Audit and has been attended by one of our Independent Non-Executives during the year.

Under the Audit Quality Board's direction, the SAQ programme has built a permanent audit quality infrastructure and suite of workstreams, all designed to deliver continuous improvement in audit quality. We are delighted that our investment and performance has been reflected in improving results for the FRC inspections in the last two years, culminating in 85% of the audits reviewed in the 2016 FRC report being graded good or with no more than limited improvements required. I am proud of the progress we have made. However, we are striving for further improvement and we will continue to invest in our people, processes and technology.

Investment in our audit teams took various forms during the year under review. For example, we increased the size of our audit team headcount by 17%, placed a greater focus on our recognition and reward system and began work with cognitive psychologists to carry out behavioral modelling. This involves identifying what our highest performing auditors do, so that our coaching programmes can help others to emulate their success.

Additionally, we carried out detailed hot file reviews on a number of our audits. Dedicated teams assessed a cross-section of more than 50 audits, with a weighting towards those engagements with higher risk factors. This work was in addition to our annual cycle of quality reviews of individual directors and partners authorised to sign audit reports. Each year that process covers more than a third of all UK colleagues holding this responsibility.

I was also pleased with the recognition we received from the Investment Association (IA) Auditor Reporting Awards 2015. There were nine award categories and we won four of them. The IA represents 200 institutional investors managing over £5.5 trillion in funds on behalf of clients worldwide, and external recognition like this is really important.

In this report we will aim to explain further how we are striving to deliver the highest quality audits. We will continue to engage with investors to understand their future needs. One way that we do this is through our *Investor Dialogue* events. For the third consecutive year, we have met with many of the leading investment firms for broad discussions on areas of interest to them. One area of particular interest was the long-term value increasingly sought by investors from their companies and the growing significance of intangible assets as drivers of that value. We have also covered the ascendency of corporate culture as an important means to govern companies and create value. These developments hint at the emergence of a new reporting and auditing paradigm – a different and better way for businesses to perform and report on what they do, in the interest of investors and the wider public. We not only have a role to play in all of this; I believe we have an important responsibility and contribution to make to building trust in business and society.

Hywel Ball
Head of Audit
Ernst & Young LLP

A report from the Independent Non-Executives

The role of the Independent Non-Executives (INEs) at EY is to provide constructive challenge to the leadership, and to bring to the foreground relevant issues that we believe worthy of examination. As a part of our duty of care to Ernst & Young Global Ltd, and our responsibility to the wider EY network, we place the public interest front and centre of the network's decision-making processes and daily activities.

This year the INE team was strengthened by the addition of two new members, taking the total up to six – one each from Hong Kong, India, Germany and the US, and two from the UK. One of our new members is Sir Chung-Kong Chow, a business leader with wide experience in East Asia, Australia and the UK, who joined as an INE from Hong Kong. The other is David Thorburn, who is on the board of the Bank of England's Prudential Regulation Authority and is a former chief executive of Clydesdale and Yorkshire Banks, who became the second INE from the UK.

This was the first full year of operation for EY's Public Interest Committee, chaired by me and made up of all six INEs plus Lou Pagnutti, Global Managing Partner – Business Enablement, together with Penny Stocks, the Presiding Partner of the Global Governance Council (GGC). We expect the Global Executive to bring to the table matters that require our attention, but we set our own agenda and feel free to ask any EY leader to join our meetings in order to answer our questions on the important issues of the day.

As INEs, our main focus is on audit quality, across EY, and we occasionally review the performance of an individual audit if that seems appropriate. This year we were pleased to see that EY's Sustainable Audit Quality programme, which I reported on last year, is now bearing fruit. Regulatory reviews have found significant improvements in the performance of member firms of Ernst & Young Global Ltd, particularly EY UK. Continued improvements here will be necessary at a time when regulators at a global and national level are raising the required benchmarks, and when audit rotation is gathering pace in a number of significant markets around the world.

Other issues considered by the Public Interest Committee include those activities that could impact on EY's reputation, such as tax advisory work, and business processes – the approach to risk management being one obvious example. We also take a keen interest in the way that EY member firms manage the balance of their resources between audit and non-audit services.

Elsewhere, we INEs have continued to play our full part on the GCC, which has settled down into its stronger and more focused role following the changes I reported last year. The other new sub-committees which were formed at that time – one for each EY Area, along with Finance and Audit, Global Chair/CEO performance and remuneration – are up and running well.

And the GGC has continued to review major strategic decisions within EY, such as a programme of alliances and acquisitions by EYG member firms that has been gathering pace, and the gradual implementation of a major new Enterprise Resource Planning (ERP) system across the EY organisation. The GGC will be keeping a watchful eye on the programme as it is rolled out across a number of major EY member firms in calendar year 2017.

As a global network, EY has established its INEs at a global level. This is in contrast to the other Big Four, which have placed their INEs at a national level, largely in the UK. But at a time when the UK regulator's expectations of our engagement in the UK practice have increased, so has our level of activity in this national marketplace. From this year, David Thorburn and I have started to attend EY UK board meetings, thereby gaining a more direct view of the firm's activities and strategies. We are non-voting attendees, but we can and do make our voices heard on EY UK's board.

At the same time, David Thorburn and I have continued to have helpful dialogues with the Financial Reporting Council (FRC) on a regular basis, helping us to understand EY UK's strengths and weaknesses relative to the competition. And we also spend time with the leaders of all EY UK's activities. Although our prime focus is on audit quality, we also have a strong interest in the reputation and culture of EY UK as a whole, conscious of the risk that a serious setback in one part of EY UK could have a contagious impact across the practice.

We both enjoy taking part in EY UK's various dialogues with different groups of investors. These are making progress, with rising numbers of attendees. Alongside the governance experts who attend, it would be good to see more people involved in actual asset allocation at these meetings. We intend to develop the investor dialogue programme further in the year ahead.

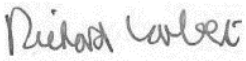
This time last year, I said that I expected in the following 12 months to see progress in the FRC's audit quality reviews of EY UK's work. The results come out after a time lag, and the firm's strenuous efforts to do better after two disappointing years were taking a while to show through. So it was very pleasing indeed to see a significant change for the better in the latest set of reviews, which were published in the spring. After what has been a very big and successful effort on the part of all those involved in our audit quality initiative, the challenge now is to push for even better results in the years ahead. This is a marathon, not a sprint, and the regulator has made it clear that what is seen as acceptable today will not be regarded as such tomorrow. Investors deserve nothing less.

Since the end of EY UK's reporting year, the FRC has published a revised version of its Audit Governance Code. This will require significant further engagement by the UK INEs in EY UK's affairs. Among other things, we will increase our focus on next year's Transparency Report, seeking to include key performance indicators on the performance of the firm's governance system and much more detailed reporting on the work of the firm's board and its INEs. David Thorburn and I are now working with EY UK's leadership to determine how best to go about these new tasks. The changes under the revised Code are not required until the firm's 2018 financial year, but we would like to incorporate as many as possible into our work in the next 12 months.

EY's INEs as a group continue to have an open and transparent relationship with the EY leadership team, which responds in a constructive way to the questions and challenges that we raise. We work together well as a group, as can be seen in the way that the Public Interest Committee is developing.

Our priorities for the coming year will include a continued focus on the Sustainable Audit Quality programme, with a requirement for further improvements in the years ahead. We also have a number of other key goals: embedding the work of the Public Interest Committee of the GGC into the working practices of the EY member firms around the world; monitoring the consequences of Brexit at a global and national level; considering the ways in which new technologies will affect the audit practice of the future; and assessing the quality of EY's efforts to strengthen its back office functions.

Finally, any stakeholder who would like to raise issues related to our work as INEs should feel free to contact me directly.



Sir Richard Lambert

Market developments

The development of our firm

Over the financial year to 1 July 2016, EY UK grew its Assurance revenue to £619m, an increase of 5% over the previous year's total of £585m. Assurance revenue accounted for 29% of the firm's overall revenue during the period.

The UK audit market

After six years in the making, the EU audit reforms came into effect on 17 June 2016. However, many companies affected by the new requirements had already begun responding by tendering their audits and rotating where appropriate. Over FY2016, we are delighted to say that we continued to make ground in the FTSE 350, winning new audit clients across a diverse range of sectors.

New audit clients included Persimmon, Renishaw, Co Op, Vedanta, and Thomas Cook, which build on our previous appointments to Royal Bank of Scotland and Royal Dutch Shell.

It's also vital that we retain our focus on audit quality, which we consider to be a key differentiator in the audit market. Audit clients rightly expect the highest standards and audit quality is an important consideration during audit tenders. Driving ever higher quality audits therefore underpins everything we do; not only will this relentless focus on high standards helps us to win new clients, we also see it as important for meeting our public interest responsibilities.

Practical implications for companies

The regulatory changes stemming from the EU audit reforms make this an exciting time for audit firms and represent an important evolution in the UK audit and professional services market.

It is encouraging that so many companies have initiated tender processes in good time. This is important for ensuring they have maximum choice, particularly because of the new tighter restrictions on the provision, by auditors, of non-audit services. From our research among FTSE 350 executives we know that the majority of companies plan to conduct tenders for both audit and non-audit services around the same time. In order to enable maximum choice at a tender, we are encouraging companies to plan at least 18 months in advance, to have a clear strategy that sets out all the professional services they are likely to need (not just audit) and from whom. They also need to understand as early as possible what services they already receive from those firms being invited to tender for the audit or other services. This can help to avoid any unnecessary limitation of their choice of preferred provider.

From EY UK's perspective as a leading provider of audit and non-audit services, we will continue to tender for new client appointments as appropriate. High levels of tendering activity do require considerable resources, including the time and attention of our senior people. However, we take our professional and public interest responsibilities extremely seriously and will not seek appointment as auditor for any company unless we are satisfied that we can deliver an independent high quality audit.

We have seen increased concentration in the UK audit market as a result of the rise in audit tendering and rotation activity since 2012. According to the Financial Reporting Council's (FRC's) report *Developments in Audit 2015/16*, since audit tendering was introduced formally into the UK Corporate Governance Code in 2012, "the Big Four share of the FTSE 350 market has risen, from 96.7% to 97.4%". This result is probably not surprising, given experience in other markets. We, along with member firms of the other major networks, anticipated that mandatory tendering and/or rotation would likely increase concentration rather than reduce it. Our argument was supported by experience in Italy, where mandatory audit firm rotation has been in place since the 1970s and where the audit market is one of the most concentrated in the world.

Audit committees

Our engagement with audit committees matters to us. Their role in managing the relationship between company and auditor, challenging what firms do and how they do it, supports better quality auditing. Now the EU audit reforms have come into effect, this engagement is about to reach new heights, especially in the area of audit tendering.

The tendering process and related responsibilities on the part of the directors and audit committee are now prescribed by law. For instance, the audit committee now has responsibility for the tender process and must identify its first and second choice candidate for appointment, giving explanations for each one (i.e., why it prefers one firm over the other). It also has to give written assurances that its recommendation is free from influence by a third party, and that no contractual arrangements have been introduced to limit the selection procedure (e.g., a bank covenant that requires the company to only appoint auditors from a certain size/category of firm).

Once the audit committee has agreed on its choices, it has to make its recommendation to the board of directors. The board in turn is required to propose an auditor or auditors for appointment. Its proposal must include the recommendation made by the audit committee or, if the directors disagree with the committee's preferred choice, the reasons for not following that recommendation.

Given that UK law also states that the tendering process should "substantially meet the requirements of Article 16(2) to (5) of the EU Audit Regulation", companies should also be mindful that the tender process does not in any way preclude the participation of smaller firms (i.e., firms that received "less than 15% of the total audit fees from public-interest entities in the member state concerned in the previous calendar year"). In addition, tender documents should "contain transparent and non-discriminatory selection criteria that shall be used by the audited entity to evaluate the proposals made by statutory auditors".

The committee's composition as a whole is also now required to have competence relevant to the sector in which the company operates, the majority of members must be independent of the company and at least one member must have competence in accounting and/or auditing.

Assurance technology

Over the past three years EY has invested heavily to create the technologies needed for the audit of the future. The overarching investment of $400m in technology innovation allows member firms' teams on audits of global companies to automate audit workflows and communicate risks more effectively. This allows us, as well as other EY member firms, to deliver audits in a streamlined and cost-effective manner.

Helix, an analytics platform, creates the equivalent of an app-store for EY global best practice analytics tools. Member firms' teams can now develop and share best-in-class algorithms and apply these on client data, securely hosted on EY platforms.

In addition, we are providing new insights to our teams and clients through the use of advanced tools such as EY GLASS, an analytics tool supporting multi-attribute journal-entry testing. This, combined with machine-learning technologies, helps us to not only understand risks better, but also to identify emerging patterns that could lead to future risk.

The audit of the future will look at other indicators beyond those constrained by structured financial data. To this end, EY UK is investing heavily in assessing our clients' cultures using various analytics tools. The understanding we gain, when combined with other structured and unstructured data observations, is giving us greater insight into potential risk areas. Based on the feedback we have received, we know that audit committees find such insights to be of great value.

The new auditing paradigm

The audit world is changing. The new, emerging audit paradigm has to reflect a more competitive audit market driven by a focus on audit quality. It must also respond to other current developments affecting our working environment, such as the proliferation of data, digital disruption, and a pervasive public cynicism towards business. If audit is to remain relevant it must address such challenges, including the changing expectations of stakeholders.

As auditors, we have to understand the needs of the investor community. As investors increase their focus on the value of intangible assets as drivers of long term value, so companies' financial statements need to ensure that they remain relevant. As the information presented in financial statements evolves, so assurance and audit services must also adapt.

For example, we are becoming increasingly involved with measuring different types of assets whose domain might have been regarded only a few years ago as the sole preserve of corporate psychologists and specialist management consultants. This is illustrated by our work on corporate culture, increasingly recognised as a key driver of good corporate governance and commercial success.

At the same time, the all-pervasive use of digital information is revolutionising our audit work, enabling us to routinely access more detailed data sets. This not only enhances the way in which tangible assets are measured and audited, reducing the need for audit sampling and its associated risks, but can also support the measurement and auditing of intangible assets such as culture (e.g., the attestation of staff surveys, attrition rates and levels of absenteeism).

Given that audit quality matters more than ever, we understand the importance of maintaining our investment in such cutting-edge aspects of our work and building on our achievements. We must continue to innovate in terms of both *how* we audit and *what* we audit, reflecting investors' growing interest in the intangible drivers of long-term value and the corresponding evolution of financial reporting.

Looking further out, EY UK is involved in a number of areas to support the audit of the future. We already have teams working on blockchain, a tool for maintaining secure distributed ledgers and other new technologies that will help the audit stay up to date.

Our audit quality indicators

We take our responsibility for helping to sustain stable capital markets seriously. Maintaining and continuing to improve audit quality is a priority for EY UK. The demands on us as auditors are increasing and thus our investment in audit quality is focused on enhancing our audits, as well as dealing with any shortcomings in our current delivery.

In the following section we discuss our Sustainable Audit Quality (SAQ) programme, our Root Cause Analysis (RCA), our training activities and our continued investment in quality. In our 2014 and 2015 Transparency Reports we included additional information about a series of Audit Quality Indicators (AQIs), which EY UK agreed along with the other largest audit firms in the UK through the Policy and Reputation Group (PRG).

We play an active role in the PRG, which convenes frequently to debate topical public interest issues that have an impact on the reputation of the firms collectively and on the profession. Two years ago, the six largest audit firms agreed that we would disclose additional information on a voluntary basis going beyond disclosures required by the Statutory Audit (Transparency) Instrument 2008 and the Audit Firm Governance Code.

These AQIs provide an insight into factors that contribute to audit quality. They include results of external and internal reviews, as well as details of investigations and any sanctions. Investment in training and results of surveys from staff are also included. We believe this is an important initiative and have again provided full disclosure for the measures agreed by the PRG. The details are set out below.

Our Sustainable Audit Quality programme

In our 2014 Transparency Report we explained that we had established a long-term Audit Quality Programme. The EY Global Sustainable Audit Quality Programme was launched in 2015. Our UK programme is aligned with the global programme and is now referred to as our Sustainable Audit Quality (SAQ) programme. Our UK SAQ programme incorporates local initiatives above the global programme. The first audits completed since the launch of the SAQ programme have now been reviewed by our UK regulators. We are pleased that these audits reflect the benefits of our investment in this programme. In particular we are pleased to report that the FRC graded 85% of our audits it reviewed as good or having no more than limited improvements required.

The Audit Quality Board that we established as a permanent aspect of our governance structure oversees all matters relating to audit quality. It has executive decision-making powers over the SAQ programme and is monitored by the EY UK board. The Audit Quality Board meets monthly, as well as running two additional strategy sessions during the year.

The SAQ programme has continued to work on all aspects of audit quality today and in the future. This includes how we recruit, train, allocate, reward and retain the best auditors. Major areas of work during the last year have included increasing the use of analytics in our audits, enhancing our work on IT controls and integration with IT specialists, as well as further investment in training. The focus on analytics will continue in the year ahead, and we have commissioned the services of cognitive psychologists as we model and seek to replicate best-in-class working practices by our teams.

Our Audit Quality Support Team (AQST), which started within the SAQ programme, reviewed over 50 audits during the 2015/16 audit cycle, providing challenge and guidance to the engagement teams and enhancing the quality of the audits. These were in-depth reviews carried out by experienced auditors independent of the audit team. The AQST has now become a business-as-usual function with a new full time leader. In 2016/17 the AQST plans to complete a similar number of detailed audit reviews supplemented by additional work on specific areas.

In our 2015 Transparency Report we outlined the significant investment EY has been making in new technology, including new audit software, EY Canvas. The first audits undertaken using this software will not be reported on by the regulators until 2017.

External reviews

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

The FRC's AQRT rates audits on a four point scale: 1, 2A, 2B and 3. In its public reports on the firms, it has historically combined 1 and 2As as "good or limited improvements required". An AQRT 2B assessment is reported as "improvements required", while 3s are reported as "significant improvements required".

The FRC published in July 2016 its report *Developments in Audit 2015/16*, which sets out further details of the results of its audit firm inspections, its main findings and the key challenges it sees for the audit profession. The FRC noted that overall, from all firms inspected, the number of audits assessed as 1 or 2A had increased from 67% to 76% in its 2015/16 inspection round, that only two audits were assessed as 3s and that there were fewer findings overall. The FRC has set an objective that, by 2019, 90% of FTSE 350 audits reviewed should be assessed as 1 or 2A. We support that objective and our investment in audit quality discussed above is aimed to enable us to meet that goal.

The May 2016 AQRT report on the firm highlighted the following results:

	2016 Report	2015 Report	2014 Report
Good or limited improvements required	17 (85%)	8 (50%)	6 (38%)
Improvements required	3 (15%)	6 (38%)	6 (38%)
Significant improvements required	0 (0%)	2 (12%)	4 (25%)

We are pleased with the continued improvement in the quality of audit engagements inspected by the FRC in the last three years. Since 2014 we have made significant investments in audit quality, as discussed above. Our RCA (discussed further below) indicates that the improvement in the quality of audits inspected this year has been underpinned by a focus on the importance of audit quality, reflecting a consistent message from EY UK's leadership and driven by earlier detailed partner involvement in audit planning.

In all of its reports for individual firms issued in May 2016, the AQRT highlights between five and seven key findings. The AQRT's key findings requiring action by EY were as follows:

- Improve the extent of challenge of management in relation to areas of judgement, in particular impairment reviews and provisions
- Improve the quality of the written communication with audit committees in relation to key judgements and estimates
- Make further improvements to the audit of revenue, embedding key messages from the firm's training and changes in the firm's methodology
- Require that more effective audit procedures to be performed to test IT controls and systems generated reports which are relied on
- Continue to strengthen the firm's monitoring of compliance with its independence policies and procedures

Further details of the findings and our actions in response are set out in the May report, which is available on the FRC's website. We are addressing the FRC's key findings and responding to the output of our RCAs discussed further below.

During the year the FRC has also completed three thematic reviews on Audit Quality Monitoring (AQM), Engagement Quality Control Reviews (EQCR) and Sampling. We have discussed with the FRC its findings arising from each of these reviews. Our response on the AQM review is set out in the section below. In relation to the EQCR review, we have provided further guidance on ensuring that our EQCR review is effective and appropriately evidenced. Following the FRC's sampling review, we concluded that no further changes were needed to our sampling guidance.

The last QAD inspection took place in 2015 and its report was issued in the spring of 2016. As in the prior year the QAD noted: "The audit work on the files we reviewed was of an overall high standard." Nine of the 11 files reviewed were rated as "satisfactory" or "generally acceptable". However, one engagement was rated "improvement required" and one "significant improvement required". The findings which drove those conclusions related to audit work on impairment testing and on a specific provision. Plans to address the specific findings on those two audits have been developed and

more generally we continue to focus on improving our work in these areas. For example, our 2016 training programme has reinforced the application of professional scepticism, particularly in the audit of valuations and estimates.

The QAD also undertook a follow-up review of one of the engagements it had reviewed in the previous year, concluding that the issues previously identified had been satisfactorily addressed.

The results of recent QAD reviews are as follows:

	2016 Report	2015 Report	2014 Report
Satisfactory	6	7	6
Generally Acceptable	3	2	3
Improvement required	1	1	0
Significant improvement required	1	0	1

EY UK is inspected every three years by the PCAOB. The PCAOB conducted its latest inspection in the autumn of 2014 and issued its report in April 2016. It inspected three engagements and reported on deficiencies in respect of two of those engagements. The deficiencies related to the testing of controls and performance of substantive audit procedures over certain accounts in the financial statements. Following the inspection in 2014, we have undertaken work to address the deficiencies identified by the PCAOB.

In addition to the public report, the PCAOB also provides a private report to the firm setting out deficiencies in the wider quality control processes operated. This report is only made public if the PCAOB believes that these deficiencies have not been appropriately addressed in the year following the issuing of the report. We have taken steps to address the concerns identified by the PCAOB and we will be discussing those actions with it in the coming months.

Internal quality reviews

Each year a review of a sample of our audit engagements is undertaken. The review is conducted in the summer months and inspects audits performed in the previous year – so audits reviewed in the summer of 2016 are primarily from audits of December 2015 accounts, although we also seek to design our sample to cover a range of audits, not just those with December year ends.

The review is performed by EY UK professionals from offices other than that in which the audit in question was undertaken, as well as a significant proportion of reviewers drawn from other EY member firms across the world. The reviews are subject to oversight from senior partners of EY member firms, which further supports the rigour, integrity and consistency of the process.

The review process is intended to cover every Responsible Individual (RI) – 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 to cover a cross-section of the audit practice. However, the selection is weighted towards those engagements with higher risk factors. Looking back over the last three years, we reviewed 42% of our RIs in 2016, 44% in 2015 and 32% in 2014.

During the year we discussed with the FRC the results of its thematic review of audit quality monitoring. In the light of those discussions we sought to improve the quality of the Audit Quality Review (AQR) process through:

- Providing further guidance to reviewers on how issues should be followed up, what constitutes appropriate mitigation of a finding and how that should be verified, to ensure that final conclusions reflect and are supported by findings
- Piloting focused reviews on four engagements during the 2016 AQR cycle
- Including a sample of UK components when group audits are reviewed
- Requiring the role of the Engagement Quality Control Review (EQCR) partner to be fully considered in the AQR process so that AQR results are considered for EQCRs in our partner appraisal process

We continue to assess the effectiveness of our process and will look to make further improvements as appropriate. 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:

	2016 Review	%	2015 Review	%
1	71	75	65	78
2	18	19	14	17
3	6	6	4	5
Total	95	100	83	100

In addition to the corporate AQR process we also undertake reviews of our public sector audit engagements. These reviews are undertaken using the same process as the corporate AQR, but are performed in December of each year, reflecting the fact that public sector audit work is undertaken in the summer. The results are provided to Public Sector Audit Appointments Ltd (PSAA) and included in its assessment of the quality of our work in this sector.

The results of recent reviews are as follows:

	2015	%	2014	%
1	5	63	6	67
2	3	37	3	33
3	0	0	0	0
Total	8	100	9	100

For audits with material findings, EY UK develops 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 are also built into the work of our SAQ programme, discussed previously. AQR results 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.

In 2015, we undertook an exercise to investigate the root causes of the findings identified by our AQR process. This work and the results are discussed further below. The 2016 AQR results will be considered as part of our 2016/17 RCA exercise.

As well as reviewing individual audit engagements, our AQR process also involves a review of our cross-firm processes and controls in a number of areas: client acceptance and continuance; consultations and pre-issuance reviews; people processes (recruitment, assignment of staff, learning and performance evaluation); and compliance with the ICAEW Audit Regulations. Changes in our processes, procedures or systems are considered in the light of findings from this review.

Root cause analysis

From 2014 onwards we have been reviewing engagements reviewed by the AQRT to understand the underlying cause of any findings identified. In the current year we extended the scope of such RCA to cover engagements reviewed in our AQR process, engagements reviewed by the QAD and also certain breaches of EY independence policies that were identified during the year.

We spent over 100 man days on the RCA and addressed 32 engagements. The primary focus of our analysis was on engagements with more significant findings, but we also sought to consider the causes of positive quality outcomes. Our approaches to RCA for the AQRT and AQR reviews were slightly different, reflecting the different populations being considered. However, our RCA for both involved interviews undertaken by senior independent partners with key members of the engagement team (including the EQCR) and, where considered appropriate, other individuals with relevant knowledge (e.g., personnel responsible for staff allocation, an audit business leader, our Professional Practice Director (PPD) etc.). In these interviews we sought to apply the 'five why' technique, where each answer was followed with a further 'why' question to seek to drill down to the key causal factor for the finding on the engagement.

We then aggregated those engagement factors in order to identify the key themes. These themes were then discussed with those responsible for our SAQ programme so that appropriate responsive actions could be planned.

As noted above, our RCA indicated that the improvement in inspection results in 2015/16 was underpinned by the right tone from the top as to the importance of audit quality, an effective SAQ programme and earlier detailed partner involvement in the design and execution of the audit.

The RCA, however, also indicated that we needed to focus further effort on:

- Improving coaching
- Seeking to simplify and standardise aspects of our guidance
- Addressing certain skill/knowledge gaps identified
- Creating the environment for future audit quality

We will continue to refine our approach to RCA. We have discussed with the FRC the results of its September 2016 thematic review of RCA, which has provided valuable insights as we develop our 2016/17 plan.

Training

Training remains an important activity in maintaining and improving audit quality. In the last two calendar years we have delivered the following mandatory structured training hours to our teams, principally relating to audit and financial reporting:

	2015	2014
Senior 2	76	70
Senior 3	69	52
Manager	72	52
Senior Manager	48	35
Director/Partner	48	35

The increase reported in 2015 reflects the training related to the launch of our new software, EY Canvas, and the additional summer training events based around a case study. As well as mandatory structured training, staff and partners undertake personal training and development specific to their needs. Staff and partners involved in audits regulated by the PCAOB undertake further specific training on relevant standards. We also set minimum continuing professional development (CPD) requirements for all partners and staff, discussed further in Volume 2.

What our people tell us

Our ability to deliver our audit quality commitment is dependent on the staff and partners who make up the individual audit engagement teams. It is therefore critical that we understand our people's thoughts and concerns on the progress we are making. We have used regular surveys and focus groups throughout the time we have run the SAQ programme to seek the views of our people, using the insights we gain to inform the work we are doing.

In addition to the annual EY global people survey measuring overall staff engagement and morale at EY member firms, we undertook a further survey of staff in our audit practice in September 2016, specifically focusing on audit quality. That survey produced the following results:

Questions	% Positive 2016	% Positive 2015
1. EY places sufficient emphasis on audit quality	93%	91%
2. Delivering quality audits is a priority for me	98%	99%
3. I delivered, supported or contributed towards the delivery of quality audits during FY16	98%	98%
4. The teams I work with had sufficient resources to enable them to deliver quality audits during FY16*	50%	36%
5. I receive sufficient training and development to enable me to deliver quality audits	84%	81%

* We have changed the question slightly in 2016 reflecting feedback received that it better helps our people to reflect on the actual experiences during the prior year. In 2015 the question we asked was "I have sufficient time and resources to deliver quality audits".

We are pleased that these results demonstrate our people's commitment to performing high quality audit and their recognition of how important this is to EY UK. The feedback on our training and development is also encouraging. The same survey also gave us great feedback on our regular communications on audit quality and the priority placed on quality by our leaders.

We have budgeted and achieved a major headcount increase in audit of 17%, which is significantly more than our business growth of 6%. We remain concerned with the response to the question on sufficiency of resources, even though the percentage of people responding positively has increased. We will continue to look closely at the factors driving this result.

In response to feedback last year, we have been reviewing our resource processes to make sure we make best use of the resources we have. We have also undertaken additional training and provided support in areas people find more challenging and time consuming. New templates and best practice examples have been provided to our teams. We have put great focus on spreading the workload across the year, recognising that the peak year-end periods are challenging for everyone. However, while these measures should result in long-term improvements, they do represent change – and this can itself increase the pressure our people feel. Such pressure is being more keenly felt in some individual offices, and we are in the process of addressing their specific needs.

Audits are challenging assignments and the work is carried out to tight deadlines. Despite this, we are pleased that our survey found such strong confirmation that our people continue to prioritise high quality audits and believe they have delivered them this year.

Regulatory findings

Our firm is regulated and subject to professional disciplinary action in cases of potential misconduct.

During the last financial year we incurred no regulatory penalties.

As noted in our 2015 Transparency Report, we remain subject to investigation by the FRC in relation to our conduct with respect to the audits of Computer 2000 Distribution Ltd. This investigation was announced during May 2014.

Delivering value to capital markets

We recognise the critical importance to capital markets of high quality audits and confidence in the audit process. Our audit work serves a socially important role.

Accordingly we were pleased that the recent YouGov survey undertaken for the FRC indicated a higher level of confidence in the audit market than at the time of the previous survey in 2014. Demonstrating improved audit quality (as discussed above) and our independence from the entities we audit (see discussion of our independence procedures in Volume 2) is fundamental to continuing to build that confidence.

As we have commented in previous Transparency Reports, we believe that the extended audit report, introduced in 2013, has brought much greater transparency to key elements of our audit planning and work. We have continued to develop our guidance to enhance the value and insight we deliver to stakeholders. We were delighted to win four of the nine awards presented at the November 2015 Investment Association Auditor Reporting Awards. For our reports on 2015 financial statements we mandated the inclusion of a section addressing "What we have concluded to those charged with governance". We hope this addresses the question often posed to us by stakeholders, "what did the auditors think?"

New auditing standards issued in June 2016, in response to the EU Audit Directive and Regulation, extend the application of the extended audit report to other listed companies and public interest entities.

Audit committees have always played a critical role in ensuring the quality of financial reporting and audit effectiveness. As discussed previously, the impact of the changes introduced by the Financial Conduct Authority, the FRC and the Prudential Regulation Authority to implement the Audit Regulation and Directive will further increase audit committee responsibilities. The FRC's recent publication, *Developments in Audit 2015/6*, contains extensive discussion of audit committee responsibilities in relation to audit tendering, the assessment of audit quality and reporting of the findings of the FRC's AQRT. We endeavour to work closely with audit committees to help them in discharging their responsibilities. As already noted, improving the quality of our communication to audit committees was one of the key messages in the FRC's report and we will continue to focus on this issue. We work with audit committees to ensure that their reports and our extended audit reports are appropriately complementary, to help stakeholders understand what we and the audit committee have done.

We continue to talk to investors, aiming to give them a better understanding of what we do and how we do it, and enabling investors to challenge us.

Interaction with investors

Engagement with the investor community is important to EY UK because the audit is ultimately for investors' benefit. Since November 2013, we have hosted biannual *Dialogue with Investors* events.

These interactive events are designed to provide greater insight on how we fulfil our public interest role. They aim to enable collaborative and constructive conversations between investors and audit partners, looking at the most pressing and topical regulatory, reporting and governance issues, and facilitate a more meaningful and lasting exchange between EY UK and leading UK institutional investors. 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.

In this past year we hosted two significant events which brought together members of the investment community, regulators, audit committee chairs of the FTSE 100 and the EY UK Independent Non-Executives, to discuss the following key topics:

- The changing regulatory landscape – are investors prepared?
- Is culture to blame for our corporate failings – is it a circle we can't square?
- How can we use innovations to improve audit quality?
- Full steam ahead? Reflections on the current environment

At the most recent event in June 2016 we discussed whether culture and the role of 'value' in today's corporate world can be measured.

During this discussion we presented the findings of our survey conducted with the FT, in which we asked 100 board members of FTSE 350 companies for their views on corporate culture. The results revealed three key messages:

1. Culture is vital to overall strategy and performance
2. Boards still need to take more responsibility for defining, shaping and monitoring culture
3. Investors need more information on organisational culture to support long term performance measurement

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, auditing, assurance and other capital market issues and look forward to evolving our dialogue in 2017.

Investing in our people

The success of EY is built on its member firms' people. EY UK aims to create and maintain a leading people culture in order to attract the very best talent, enabling us to provide high quality services to our clients.

Our recruitment strategy is aligned to EY's diversity and inclusion (D&I) objectives, so that we recruit the best quality people from the broadest talent pools. In the 2016 financial year, EY UK recruited 4,000 people, including over 1,500 students, 930 graduates, 500 undergraduates and 140 school leavers.

In August 2015, EY UK introduced a new student recruitment process that is fair and inclusive, while maintaining very high intellectual standards. Following a detailed review and validation, we removed the up-front academic screening criteria (UCAS requirements and degree classification). The new robust recruitment process focuses on an individual's strengths and future potential, rather than academic performance.

To create strong future talent pipelines we run a number of undergraduate programmes. The EY Assurance Scholarship, run in collaboration with Bath, Warwick and Lancaster Universities, gives students the best of both worlds – university life, paid work experience and a generous bursary while studying towards a professional qualification.

Over the last five years, we have developed and invested in our school-leaver recruitment and are very proud to have been voted Number 1 Employer for School Leavers for 2015-16 by RateMyApprenticeship.co.uk. Our Skills Academy allows year 12 students the opportunity to experience life at EY UK for three days and make a more informed decision about their future.

At EY UK, flexible working is embedded in our culture. In 2016 we launched our 'Reconnect' programme designed to support women returners. For more information on all our recruitment programmes and initiatives visit ukcareers.ey.com.

Valuing diversity and inclusiveness

In our increasingly interconnected world, developing inclusive leaders who can connect and engage with anyone – regardless of their background, style or culture – is a crucial part of EY UK's approach to people and clients.

Over the last two years we have focused on ensuring that we build the skills of all our people to help them work in teams and lead in an inclusive manner, implementing an extensive Inclusive Leadership Programme. This programme has now been delivered to 84% of our partners and over 1,500 of our managers up to directors.

We are proud that EY member firms are regularly cited by external organisations as being leaders in diversity and inclusiveness and for providing an excellent working environment.

EY UK has signed up to the Government Equalities Office 'Think, Act, Report' framework, but has taken it a step further. As well as reporting on gender, we also provide black and minority ethnic (BME) statistics. EY UK is also a signatory to HM Treasury's Women in Finance Charter.

EY UK aims to have at least 30% female and 10% BME representation in our new partner intake, measured over a rolling three-year period. In the three years to July 2016, 27% of our new partner intake were female and 12% BME. In the 2016 financial year, 29% of our new partners were female and 13% BME. We have a longer-term aim to achieve the target levels of representation on both our leadership team and within our wider partner population; our partner representation is now 20% female and 8% BME. In addition to our Inclusive Leadership Programme, we have a number of targeted programmes aiming to ensure that everyone in our diverse talent base has an equal chance of progressing through to leadership positions.

Having the right mix of talent is one of our characteristics for highest performing teams. Forming teams with a good mix of talent enables us to excel in volatile markets, solve complex problems and deliver quality results.

Our governance

Volume 2 describes our legal structure, ownership and governance, as well as the EY network arrangements, in some detail. However, we highlight below certain aspects that we think are important to our stakeholders.

Oversight

As is explained in Volume 2, EY is a globally integrated network. Part of our structure includes Ernst & Young Europe LLP (EY Europe – see Volume 2), in respect of which we sought and obtained authorisation from the ICAEW. As a normal condition of authorisation, all partners of EY Europe (i.e., not just those who are UK based or those who are accountants or auditors) became affiliated members of the ICAEW. This means that they are all subject to, among other things, the ICAEW's ethical and professional standards.

Under this model, the EY UK board and management (the UK team) is subject to oversight by EY Europe and to the governance agreements established by Ernst & Young EMEIA Ltd and EYG. 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. EY UK's management participates in a number of international EY fora, which enables the team to share best practice with peers, along with other approaches and different techniques for running EY UK sustainably.

While decision making is local, the regular review process provides another level of informed challenge to proposed decisions and plans. To reinforce the importance of engaging with the challenges that are made, Area leadership provides input into the remuneration decisions for the UK team. This approach applies to all our service lines, but there are particular features that apply to the audit practice.

For instance:

- In certain kinds of decisions on audit engagements, professionals in positions at an Area or Global level are consulted so that EY member firms achieve consistent outcomes where the fact patterns are the same
- The audit engagements that are selected for our internal quality inspections are approved by professionals at an Area level so as to avoid an inappropriate population being selected
- The decisions of the EY UK Audit Independence team are reviewed by the EY global independence team as appropriate

EY UK leadership appreciates the need to listen to the views of EY UK partners about strategy, management and governance more generally. Such engagement and feedback is achieved through a Partner Forum to which EY UK partners elect members. Some of these elected partners serve on senior bodies outside the UK including the Global Governance Council (as referred to in Volume 2).

Finally and for sake of completeness, following the implementation of the EU's 8th Company Law Directive, a group of independent audit regulators came together to form the EY European College of Supervisors (now the EY SubGroup of the European Audit Inspection Group). EY member firms have engaged extensively with the group since 2010. As part of that engagement, EY makes available to the EY SubGroup detailed information describing the operating model and processes for the audit practices of EY member firms. This has been supplemented by discussions with leaders from EY Europe in areas such as assurance, audit quality, independence, human resources and risk management, not to mention senior management. This engagement continues on a regular basis.

Conclusion

We hope that Volume 1 of our Transparency Report has provided helpful insights on how EY UK performs its public interest role and welcome constructive suggestions from our stakeholders for enhancing future reports.

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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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