

EY ERNST & YOUNG

Integrity in Question: why Ernst & Young should face a temporary ban from public contracts

Spotlight on Corruption on Friday 13th November wrote to the Crown Commercial Service to highlight a catalogue of corporate failings at the accounting firm Ernst & Young (EY) which raise serious questions about EY's suitability for performing government contracts. In light of those failings, **we are calling on the Cabinet Office to review whether EY should be allowed to bid for government contracts**, and in particular three upcoming framework contracts to provide audit, consultancy and legal services to UK government departments and the wider public sector.

Background

EY is a multinational corporation that provides audit, consultancy and other professional services to public and private sector clients in countries across the world. UK fee income grew to £2.45 billion in 2019¹ and the firm reported global revenues of \$37.2 billion in 2020.² The Cabinet Office has designated EY as a 'strategic supplier', one of the large corporations on whose services the UK government has become increasingly dependent.³

The Crown Commercial Service is an executive agency, sponsored by the Cabinet Office, that manages the procurement of common goods and services and leads on the UK government's procurement policy, including establishing procurement frameworks to be used by the public sector.

Why ban companies from public contracts?

Banning companies for a set period of time from public contracts (otherwise known as debarment) is increasingly recognised globally as an effective tool to protect the integrity of public contracting and prevent corruption, fraud, money laundering and other corporate wrongdoing.

Where companies have engaged in unethical, damaging and illegal behaviour it brings into question whether they are a reliable party for government to do business with. Removing companies' ability to bid on public contracts when they have engaged in such behaviour is a really powerful way to make sure companies behave responsibly and are held to account when they don't.

In the UK, the government spends £284 billion a year buying goods and services from companies. Banning companies that engage in misconduct is a way of:

- making government procurement fairer - it creates a level playing field for those companies that do the right thing;
- making sure taxpayer money is not lost or wasted by unreliable contractors;
- making sure that companies get their act together and root out misconduct and wrongdoing.

Currently, in the UK, rules that allow government bodies to debar companies have been almost unused for years.

In the case of EY, banning the company for 3 years from UK public contracts would send an incredibly powerful message that the government will not give public contracts to companies that engage in misconduct as damaging as audit failure and do not get their house in order.

Who are the 'Big Four'?

The largest multinational professional services firms – EY, PricewaterhouseCoopers, KPMG and Deloitte – are commonly referred to as the 'Big Four'. These firms dominate the audit sector and provide a diverse range of other services, including legal advice and consultancy, to companies and governments across the world.

The dominance of these corporate giants cannot be overstated. In 2019, the combined revenues reported by the Big Four grew to US\$155 billion. At the national level, the four firms audit 97% of the 350 largest companies listed on the London Stock Exchange.⁵ The firms are also awarded contracts across the UK public sector, despite costing twice as much as civil servants.⁶ Ministerial departments spent £385 million on audit and consulting work by the Big Four in 2019/20.⁷ The government's reliance on firms for consultancy has led to criticism from within government.⁸

The Big Four have been involved in many of the high-profile corporate accounting scandals in the UK in recent years, from BHS, Carillion, the Co-op Bank, Ted Baker, Rolls Royce, through to London and Capital Finance, and many others. The UK's regulatory body, the Financial Reporting Council (FRC), has described as "unacceptable" the continued poor standard of audits by the Big Four and called on the firms to improve corporate reporting.⁹

While all of the Big Four have been criticised for audit failure in recent years, in the past 2-3 years EY in particular has been at the heart of a string of high-profile corporate fraud and money laundering scandals. The egregious nature and extent of EY's audit failure and misconduct raises very serious questions about EY's approach to audits and its suitability as a public contractor.

While it is clear that wide-ranging reform is needed of the entire audit sector, by banning EY from public contracts the government can make a clear and powerful statement of intent to the Big Four that corporate conduct and audit standards must improve.

What is grave professional misconduct?

Under current procurement rules, companies can be banned from public contracts for 3 years when they are found to have engaged in grave professional misconduct.¹⁰

'Grave professional misconduct' is a term used in UK and EU procurement law when companies have engaged in "wrongful conduct" that raises questions about their integrity. There is no single definition but it can include a conviction or a breach of ethical standards. Indeed, a government minister confirmed in Parliament that it is "*quite a low threshold*".¹¹

Public authorities can decide not to ban companies if they find that a company that engaged in wrongful conduct has changed its ways. But the rules on this are quite strict - a company has to have paid compensation to those who were damaged by the misconduct, collaborated properly with any investigations by authorities and undertaken real corporate change to ensure the wrongdoing doesn't re-occur, including sacking the relevant people.

What exactly did EY do wrong?

EY's catalogue of misconduct includes breaching professional and ethical standards, failing to report money laundering, failing to conduct audits in line with generally accepted standards, and serious audit failure.

This misconduct has been criticised by a UK high court, and has been the subject of various regulatory fines, and ongoing investigation by audit bodies as well as civil litigation across Europe, including by the UK's Financial Reporting Council (FRC).

It includes:

- The UK High Court found, in April 2020, that EY committed professional and ethical misconduct for breaching the International Federation of Accountants (IFAC) Code principles of integrity and objectivity after advising a client to mask the source of smuggled gold.¹² Mr Justice Kerr's ruling was deeply critical of EY's "improper" audit procedures which included altering the review period to obfuscate the existence of cash transactions and of attempting to "sweep under the rug" its auditor's concerns.
- Ongoing investigations by the FRC for its audits in two major fraud cases that resulted in companies collapsing. The FRC is investigating EY's audit of NMC Health PLC, the former FTSE 100 healthcare operator that collapsed into administration after \$4 billion in hidden debts were identified on its books.¹³ It took a due diligence firm, Muddy Waters, to highlight the irregularities which should have been picked up by its auditors - EY.¹⁴ The FRC is also investigating EY for its audit of London Capital and Finance Plc,¹⁵ another company that collapsed amid accusations of fraud which are under investigation by the Serious Fraud Office and the Financial Conduct Authority.¹⁶
- Ongoing investigations into audit misconduct by Denmark's business watchdog, the Danish Disciplinary Board, which is bringing two EY auditors before a disciplinary board for major audit failure in relation to the world's largest ever money laundering scandal - Danske Bank.¹⁷ The bank was found to have handled over €200 billion in suspicious cash transactions without its auditors apparently kicking up any fuss.¹⁸ Although Danish police dropped a criminal investigation into whether EY broke Denmark's anti-money laws in April 2020, the Danish Disciplinary Board is investigating whether EY audit partners breached generally accepted audit standards. Its investigation is due to conclude in 2021.
- Ongoing investigations into audit misconduct by Germany's audit regulator, APAS, which is investigating EY's role in a massive fraud case involving online payments company Wirecard, exposed by the Financial Times.¹⁹ Wirecard collapsed in June this year after admitting €1.9 billion was missing from its accounts. According to reports, EY auditors relied on screenshots and documents provided by a third party trustee and Wirecard employees instead of requesting the information from the banks handling Wirecard's accounts.²⁰ This practice continued for three years until EY reported its concerns to the German regulator BaFin a week before Wirecard filed for insolvency.²¹ A full parliamentary inquiry in Germany's Bundestag has been set up to investigate what one German MP called "*an accounting scandal that has no precedent in Germany's postwar history.*" EY meanwhile is alleged to have:
 - failed to undertake routine audit procedures to verify the existence of €1 billion in cash in Wirecard's Singapore bank accounts;²² and
 - closed down an internal investigation at the behest of a Wirecard executive into concerns raised by an employee in 2016 that Wirecard senior managers had committed fraud and attempted to bribe an auditor.
- Regulatory fines in the past three years across Europe for violation of audit, conflict of interest and competition rules. These include:
 - A €776,850 fine in October 2020 from the Spanish audit regulator (ICAC) for violation of audit regulations during the course of its 2015 audit of Bankia;²³

- A €165,000 fine in 2018 from the Netherlands Authority for Financial Markets for violating conflicts of interest rules by offering advisory services to the statutory body under audit thereby jeopardising the independence of the auditor;²⁴ and
- A share of a €23m fine in 2017, from the Italian Competition Authority (ICA) for participating in a cartel with the other Big 4 firms to land public contracts co-financed by the EU. The ICA described the audit firms' conduct as "one of the most serious violations of competition law."²⁵
- Multiple investor suits against EY including:
 - a £1 billion lawsuit on grounds of negligence against EY by Alvarez & Marsal, the company overseeing NMC's administration including investigating the extent of the fraud;²⁶
 - several class actions by German investors against EY for audit failure in the Wirecard case.²⁷

Does EY's complex corporate structure shield it from liability?

The EY organisation is a transnational network of entities bound together by confidential agreements. This complex corporate structure should not however shield Ernst & Young LLP – the entity that is awarded UK public contracts – from a review of its suitability to be a UK public contractor following the April 2020 High Court Ruling.

Mr Justice Kerr found that four UK-registered EY entities which committed ethical and professional misconduct were acting in concert, jointly with each other and on behalf of the others as well as themselves.²⁸

Under EU law, a parent company can be responsible for the actions of its subsidiary where the two comprise a "unitary organisation of personal, tangible and intangible elements, which pursue a specific economic aim on a long-term basis."²⁹ Equally, where there is a single economic entity, the misconduct of a parent entity will be relevant for the purposes of its subsidiary.

The High Court ruling found that Ernst & Young Global Limited and local audit firms including Ernst & Young LLP are structurally and strategically united through a series of interlocking covenants, clear governance structures and reporting lines, and an obligation for local firms to submit to the discipline of the EY organisation. These include that:

- EY entities agree to abide by the regulations of Ernst & Young Global Limited and to incorporate them into their constitutions, to share knowledge and information, comply with global objectives and strategies, and implement decisions made at a global level; and
- EY has a global code of conduct that sets the standards required of everyone involved in the organisation.³⁰

Furthermore, under UK procurement regulations, subsidiaries of companies engaged in misconduct can be excluded where the body engaging in misconduct has powers of decision, representation or control over those subsidiaries.³¹ This is demonstrably the case with Ernst and Young LLP - the body bidding for UK contracts. Mr Justice Kerr found that Ernst & Young Global Limited exerts "decisive influence over and de facto control over the activities of locally based EY organisations."³²

Meanwhile Ernst & Young Europe LLP, a UK-based limited liability partnership named in the April 2020 judgement, has voting control over Ernst & Young LLP.³³ EY UK Chairman, a board member

of Ernst & Young LLP,³⁴ reports directly to EY's Global Chairman/CEO,³⁵ and is also a member of Ernst & Young Europe LLP.³⁶

The damning court judgment against both Ernst & Young LLP's parent entity and the organisation's global coordinating body, the catalogue of wrongdoing by other connected EY entities, and the indication that Ernst & Young LLP is part of the single economic entity, should be seen as highly significant considerations for the Cabinet Office when assessing EY's suitability for public contracts.

Why does it matter?

"Auditors have a unique advantage in having the right to see everything that goes on in a company and to assess whether that trust is deserved". Sir Donald Brydon CBE, December 2019.

Auditors have a duty to spot fraud, corruption and money laundering, to properly investigate signs of it when they do come across it, and to report it. Where a company's accounts have any errors or highlight fraud, audit firms have a duty to report their suspicions to the company's management and the appropriate regulatory and enforcement bodies.

The failure of audit companies to fulfil these duties imposes huge economic and social costs on society. Investors rely on auditor sign off on company accounts to work out where to invest individual and work pensions. The costs from accumulated audit failure rob citizens of their investments and undermines the integrity of markets as a whole.

EY's failure as auditors to spot fraud has arguably contributed to several corporate collapses which have imposed huge costs on the market and ordinary investors. EY's audit failures also allowed two major money laundering scandals to continue for several years unchecked with hugely damaging results to citizens in affected countries, including the UK.

In the Dubai gold laundering case, EY should have reported money laundering and flagged concerns about the accounts of its client, Kaloti. Kaloti was buying gold from an organised crime gang linked to drug money laundering from the UK and elsewhere in Europe, as well as conflict ridden countries such as Sudan and the Democratic Republic of Congo, where such laundering fuels armed conflict and robs the countries of millions in tax revenues. Instead of exposing it, a UK high court found that EY covered up evidence of the laundering and conspired to hide the cash payments.³⁷

In the case of Danske Bank, EY should have raised the alarm in relation to the bank's financial statements it was auditing in 2014 when billions of euros worth of suspicious transactions were flowing through the bank. EY's failure to do so meant that a vast shadow banking system used by Putin in Russia and President Aliyev and his family in Azerbaijan (including senior regime figures and oligarchs) robbed those countries of resources, and was used to finance serious criminality including illegal arms trafficking to Iran and North Korea.

Accountability Gap – why current mechanisms are not strong enough

Given the key role effective audit plays in the functioning of a healthy economy and the uncovering of criminality, audit failure should result in robust sanctions. However, the UK's current regime for holding auditors to account is widely recognised to be far too weak.

The FRC's largest fine so far (against Deloitte and two of its partners for misconduct in relation to the audit of Autonomy Corporation Plc) was £15 million - equivalent to just 0.4% of Deloitte's £4.31 billion annual revenues for the same year. In Parliament, the FRC has been branded as a *"toothless tiger"* for its record on enforcement and for failing to *"provide a sufficient deterrent against poor boardroom behaviour."*³⁸

Two recent reviews commissioned by the government into the FRC and audit regulation as a whole (undertaken by Sir John Kingman³⁹ and Sir Donald Brydon⁴⁰) have advocated for the FRC to be replaced with a new regulator, the Audit, Reporting and Governance Authority (ARGA) - which would be given statutory footing and new powers to set up a fraud register and an auditor fraud panel. ARGA is also expected to add some much-needed clarity on audit firms' obligations to take action to detect fraud on a company's books.

These measures are crucial to improving audit governance in the UK. However, progress on these reforms has been slow.⁴¹ Furthermore, unless the new Audit Authority has the political will to impose robust sanctions where audit firms engage in misconduct, auditor accountability will remain a pipedream.

Sending a strong message to audit firms

Unless companies like EY that have a strong monopoly on public contracts know that they will face consequences for poor behaviour and misconduct, there is little incentive for them to perform those contracts as efficiently and as well as possible.

That's why we're calling for the Cabinet Office to review the evidence we are presenting about EY's misconduct with a view to excluding EY for grave professional misconduct until it's cleaned up its act. That would send a clear and strong message about the kind of standards that the government expects of companies winning public contracts.

This review must include getting an independent assessment made of EY's corporate procedures that have allowed the catalogue of misconduct we lay out in our letter and what reforms are needed within EY to make sure this does not happen again.



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Spotlight on Corruption works to end corruption within the UK and wherever the UK has influence.

Our vision is for a society where strong, transparent, and accountable institutions ensure that corruption is not tolerated.

We believe that by holding the UK government to account for enforcing its anti-corruption law and scrutinising the performance of the UK enforcement bodies and the UK courts, we can help end impunity for corruption.

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Photo: 'Ernst & Young' - original version taken by Dr. Avishai Teicher. Photo reproduced here under a Creative Commons Attribution-Share Alike 3.0 Unported license. Some minor modifications have been made to the original photo.

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- ³ <https://www.theguardian.com/politics/2020/sep/29/whitehall-infantilised-by-reliance-on-consultants-minister-claims>
- ⁵ <https://www.ft.com/content/8ade6fa4-a787-11e8-8ecf-a7ae1beff35b>
- ⁶ <https://www.ft.com/content/636d7f58-3397-11ea-a329-0bcf87a328f2>
- ⁷ Tussell (October 2020) Analysis of Spend by Ministerial Departments on Major Consulting Firms, 2017/18 - 2019/20
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- ⁹ <https://www.theguardian.com/business/2020/jul/06/uk-big-four-accountancy-audit-frc-kpmg-pwc-deloitte-ey>
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³³ Ernst & Young LLP's 2019 annual report posted at Companies House states that is under the direct control of Ernst & Young Europe LLP. <https://find-and-update.company-information.service.gov.uk/company/OC300001/filing-history>

³⁴ Ernst & Young LLP's 2019 annual reports posted at Companies House refers to Steve Varley as a 'board member.' <https://find-and-update.company-information.service.gov.uk/company/OC300001/filing-history>

³⁵ https://www.ey.com/en_es/news/2020/01/ey-announces-appointment-of-steve-varley-as-first-ey-global

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³⁷ <https://www.judiciary.uk/wp-content/uploads/2020/04/Rihan-v.-EY-Global-Ltd-and-others-Approved-Judgment-17-April-2020.pdf>; see also <https://www.bbc.com/news/uk-50194681>

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