Item 5.2: Receive Report on Audit Fieldwork and Conclusions

Philip Gunn
Partner, Ernst & Young LLP

Finance & Audit Committee Meeting
ERCOT Public
May 13, 2013

Electric Reliability Council of Texas

2012 Audit Results

May 13, 2013

Ernst & Young
Quality In Everything We Do

Ernst & Young LLP
401 Congress Avenue, Suite 1800
Austin, TX 78701

Tel: 1 512 478 9881
www.ey.com

The Finance and Audit Committee
Electric Reliability Council of Texas, Inc.

April 29, 2013

Dear Members of the Finance and Audit Committee,

We are pleased to present the results of our audit of the financial statements of the Electric Reliability Council of Texas, Inc (ERCOT).

Our audit was designed to express an opinion on the 2012 financial statements. In accordance with professional standards, we obtained a sufficient understanding of internal control to plan the audit and to determine the nature, timing, and extent of tests to be performed. However, we were not engaged to and we did not perform an audit of internal control over financial reporting.

This report is intended solely for the information and use of the Finance and Audit Committee and management. It is not intended to be, and should not be, used by anyone other than these specified parties.

Very truly yours,

Philip J. Gunn
Partner

Table of contents

2012 audit results

Significant accounting policies and estimates/Areas of audit emphasis

Provided below is a summary of the Company's significant accounting policies and accounting estimates, which are in accordance with US GAAP and consistent with industry practice:

Description of significant accounting policy/estimate/area of emphasis	Our views on the quality and application of accounting policy and reasonableness of estimate
Systems under Development	The Company's approach and methodology for capitalizing both internal/external costs systems under development appear reasonable and were consistently applied. Systems under Development were $10M at 12/31/2012, compared to $9.9M at 12/31/2011. EY tested amounts capitalized in the current year, noting proper capitalization.
Impairment of long-lived assets	There were no indicators of impairments during 2012. Management's policy for assessing the Association's assets for impairment is consistent with the prior year and is considered to be reasonable.
Regulatory assets and liabilities	The Company's approach and methodology for deferring revenues and costs under FAS No. 71 is reasonable and supportable based on specific decisions made by regulators that have provided evidence that it is probable that the cost or obligation will be included in amounts allowable for recovery or refund in future rates.
Notes payable	EY confirmed notes outstanding as of December 31, 2012. We also reviewed the two new debt agreements entered into during 2012 for $80M of senior notes and a $125M revolver. Amounts are properly stated and appropriate disclosures are made in the notes to the financial statements..

2012 audit results (cont.)

Significant accounting policies and estimates/Areas of audit emphasis

Provided below is a summary of the Company's significant accounting policies and accounting estimates, which are in accordance with US GAAP and consistent with industry practice:

Description of significant accounting policy/estimate/area of emphasis	Our views on the quality and application of accounting policy and reasonableness of estimate
Derivatives activities	The Company's derivatives agreements expired in 2012. No new agreements were entered into during 2012.
Market Settlement Liabilities	Increase in market settlement liabilities of approximately of \$33.3M (primarily due to \$41.3M in CRR received from the CRR annual auctions held in November and December 2012), offset by a decrease of (\$7.9M) in prepaids received from market participants. EY tested the 2012 increases and decreases to the market settlement liability by vouching the cash both due to and due from ERCOT for certain monthly and annual auctions.
Cash	EY confirmed all cash and restricted cash accounts. Additionally, we confirmed all significant security deposit amounts at 12/31/12.
Revenue Recognition	EY tested the Company's revenue recognition of the System Admin Fee (\$136.3M) and the Nodal Surcharge (\$122.6M which is offset completely due to the FAS 71 entry related to costs incurred), in addition to the Fee Assessment revenue of \$13M.

Summary of required communications

Provided below is a summary of required communications between the audit team and those charged with governance.

	Communicate when event occurs	Communicate on a timely basis, at least annually
Overview of the planned scope and timing of the audit		X
Auditor's responsibility under generally accepted auditing standards, including discussion of the type of auditor's report we are issuing and if there are any events or conditions that cause us to conclude that there is substantial doubt about the entity's ability to continue as a going concern		X
Our views about the qualitative aspects of the entity's significant accounting practices, including:		
▸ Accounting policies		X
▸ Sensitive accounting estimates		X
▸ Financial statement disclosures and related matters		X
▸ Significant unusual transactions	X	
Uncorrected misstatements		X
Material corrected misstatements		X
Significant deficiencies and material weaknesses in internal control	X	X
Our responsibility, any procedures performed and the results relating to other information in documents containing audited financial statements		X
Fraud and illegal acts involving senior management and fraud and illegal acts that cause a material misstatement of the financial statements	X	
Independence matters		X
Representations we are requesting from management		X
Changes to the terms of the audit with no reasonable justification for the change	X	

Summary of required communications

	Communicate when event occurs	Communicate on a timely basis, at least annually
Significant findings and issues arising during the audit relating to related parties	X	
Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management	X	
Significant difficulties encountered during the audit	X	
Disagreements with management	X	
Management's consultations with other accountants	X	
Findings regarding external confirmations	X	
AICPA ethics ruling regarding third-party service providers		X
Other findings or issues regarding the oversight of the financial reporting process	X	

Required communications

Area	Comments
Overview of planned scope and timing	Our 2012 audit was primarily substantive in nature with all of our procedures performed as of the balance sheet date. Our audit scope is consistent with the plan communicated on October 31, 2012.
Auditor's responsibility under generally accepted auditing standards, including discussion of the type of auditor's report we are issuing and if there are any events or conditions that cause us to conclude that there is substantial doubt about the entity's ability to continue as a going concern The financial statements are the responsibility of management as prepared with the oversight of those charged with governance. Our audit was designed in accordance with auditing standards generally accepted in the United States, as established by the American Institute of Certified Public Accountants, to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control over financial reporting. Accordingly, we will express no such opinion. An audit also includes the evaluation of the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the evaluation of the overall presentation of the financial statements.	Based on our audit of the financial statements, there is not substantial doubt about the entity's ability to continue as a going concern. Our responsibilities are included in our audit engagement agreement. Upon completion of our remaining audit procedures, we currently expect to issue an unqualified opinion on the Company's financial statements for the year ended December 31, 2012.

Required communications

Area	Comments
Our views about the qualitative aspects of the entity's significant accounting practices, including accounting policies, sensitive accounting estimates, financial statement disclosures and related matters, and significant unusual transactions	Significant accounting policies are described in the notes to the financial statements. Management has not selected or changed any significant accounting policies or changed the application of those policies in the current year. We are not aware of any significant accounting policies used by the Company in controversial or emerging areas or for which there is a lack of authoritative guidance. We have included a discussion of our views and comments within the section titled "Significant accounting policies and estimates/Areas of audit emphasis" .
Uncorrected misstatements	No current year uncorrected misstatements were identified in connection with our audit of the 2012 financial statements.
Material corrected misstatements	No material corrected misstatements were identified in connection with our audit of the 2012 financial statements.
Significant deficiencies and material weaknesses in internal control	No material weaknesses were identified.
Our responsibility, any procedures performed and the results relating to other information in documents containing audited financial statements	Not applicable.

Required communications

Area	Comments
Independence matters	We are not aware of any matters, that in our professional judgment, would impair our independence.
Representations we are requesting from management	We will obtain from management a signed letter of representations related to the audit.
Changes to the terms of the audit with no reasonable justification for the change	None.
Significant findings and issues arising during the audit relating to related parties	None.
Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management	None.
Significant difficulties encountered during the audit	None.
Disagreements with management	None.
Management's consultations with other accountants	None of which we are aware.
Findings regarding external confirmations	None.

Required communications

Area	Comments
Fraud and illegal acts involving senior management and fraud and illegal acts that cause a material misstatement of the financial statements	We are not aware of any matters that require communication.
AICPA ethics ruling regarding third-party service providers	From time to time, and depending on the circumstances, (1) we may subcontract portions of the Audit Services to other Ernst & Young firms, who may deal with the Company or its affiliates directly, although Ernst & Young alone will remain responsible to you for the Audit Services, and (2) personnel (including non-certified public accountants) from an affiliate of Ernst & Young or another Ernst & Young firm or any of their respective affiliates, or from independent third-party service providers (including independent contractors), may participate in providing the Audit Services. In addition, third-party service providers may perform services for Ernst & Young in connection with the Audit Services.
Other findings or issues regarding the oversight of the financial reporting process	There are no other findings or issues arising from the audit that are, in our judgment, significant and relevant to those charged with governance regarding the oversight of the financial reporting process.

Appendix A

Additional reports required under NYSE rules

Additional reports required under NYSE rules

Ernst & Young's internal quality control policies

Our reputation for providing quality professional services in an independent, objective and ethical manner is key to our success as independent auditors. Our strong commitment to quality services has led the firm to adopt a comprehensive set of quality control policies and other safeguards that are applicable to every audit engagement. Like any other system of internal control, no single control or safeguard provides us with the assurance that our professionals comply in all instances with applicable professional standards and the firm's standards of quality. Working in tandem, however, these controls and safeguards provide a comprehensive system that serves to prevent or detect in a timely manner matters that without corrective action could result in substandard performance. As a result, we believe that the firm's system of quality control for our accounting and auditing practice meets the requirements of quality control standards adopted by the Public Company Accounting Oversight Board for a public company accounting and auditing practice. The following is a summary description of some of Ernst & Young's quality control policies and other safeguards for our accounting and auditing practice.

Instilling professional values

Tone at the top — Ernst & Young's Executive Board and senior management regularly communicate and reinforce the firm's expectations and the importance of performing quality work and complying with the firm's policies. The Ernst & Young culture strongly supports collaboration and consultation and places special emphasis on the importance of consultation in dealing with complex and/or subjective accounting, auditing, reporting, SEC and independence matters. We also emphasize the importance of determining that the company we audit has correctly followed our advice when necessary.

Organizational structure built around quality – Reflective of our commitment to quality, the firm's Quality and Risk Management (Q&RM) function, led by one of the firm's vice chairs, is responsible for overseeing firmwide quality initiatives in each of our service lines. For example, the Q&RM group is responsible for establishing firm policies and processes and consulting on independence matters for all of our service lines.

The independence function within the Q&RM group is comprised of a dedicated centralized group of partners and other professionals, as well as independence partners who are physically located in each of the firm's geographic operating regions. They work closely with the technical resources located in our region practices to identify and resolve independence issues affecting companies. The Vice Chair of Quality and Risk Management reports directly to the Managing Partner of the Americas and is a member of the Executive Board.

The Assurance Professional Practice and Risk Management function, also led by one of the firm's vice chairs, is responsible for establishing firm policies and methodologies and consulting on accounting, auditing and SEC reporting matters, as well as practice monitoring and risk management activities for our accounting and auditing practice. The Professional Practice and Risk Management function is comprised of highly qualified, seasoned partners and senior managers in technical support groups such as the National Accounting group in New York, the National SEC group in Washington and the Americas Auditing group in Cleveland.

Additional reports required under NYSE rules

In addition, the Professional Practice and Risk Management function includes a National Professional Practice Director (PPD) network comprised of partners physically located in each of the firm's geographic operating regions.

The PPD network is a key part of our consultation process so having it geographically located within the operating regions helps the network be more knowledgeable about our people and the companies we audit, as well as more easily accessible for consultations. It is important to note that although the PPD network is located within the operating region it is independent of the operating region leadership. The partners in the network report to and are evaluated and compensated by the Vice Chair of Assurance Professional Practice and Risk Management to provide greater assurance on the objectivity of our consultation process.

Given the volume and complexity of new accounting, reporting and regulatory matters, we continue to evaluate our resources dedicated to improving the quality of our work and are committed to increasing them when needed.

Code of professional conduct — The Ernst & Young Global Code of Conduct was developed to provide an ethical framework for all of our activities. All partners and employees are asked to sign an annual confirmation statement that they have read the Code of Conduct carefully, have become familiar with the elements of the Code, understand their responsibilities with respect to its requirements and agree to abide by its provisions as a condition of continued employment or association.

Ethics hotline/website and Ethics Oversight Board — The firm's leadership has clearly communicated to our partners and employees an expectation of personal responsibility to speak up and pursue an understanding of any matter pertaining to ethics. Although, in most instances consultation with client service partners, business unit leaders or others will resolve a matter, our EY/Ethics hotline and EY/Ethics website, which supplements the phone-based hotline, were designed to provide another — and confidential — way for our people to raise concerns about unethical or illegal actions, violations of professional standards or other actions inconsistent with the Ernst & Young Global Code of Conduct. In addition, our Ethics Oversight Board, reporting directly to the Executive Board and comprised of senior partners in the firm, provides ongoing monitoring of the practices and principles that guide the way we do business.

Independence — Ernst & Young has a comprehensive set of independence policies. The firm's written policies cover relationships with restricted entities as well as all other professional and regulatory independence requirements. Our independence policies and processes comply with the SEC's auditor independence rules. Compliance with the firm's policies and procedures is tested in several ways. Professionals who do not comply with professional or regulatory requirements are subjected to disciplinary sanctions.

Document retention — The firm has a comprehensive Retention of Records policy that applies to all of our service lines. This policy is intended to confirm that professional standards on working papers are complied with and that appropriate documents are retained as long as necessary for business, legal and regulatory purposes. The policy emphasizes that all documents must be preserved whenever any person becomes aware of any actual or reasonably anticipated claim, litigation, investigation, subpoena or other government proceeding involving Ernst & Young or one of the companies we audit that may relate to our work.

Additional reports required under NYSE rules

Audit performance

Audit methodology — As a result of substantial investment and our focused efforts to continually maintain current audit methodologies and supporting tools, our auditors are well equipped to perform audits of the financial statements of companies of varying sizes and complexities, including integrated audits of internal controls over financial reporting when required. The Ernst & Young Global Audit Methodology provides a framework for application of a consistent thought process to all audits. The methodology contemplates team-based audit service delivery and allows alternative approaches depending on the company's circumstances, professional judgment and audit team input. We make enhancements to our audit methodology on a regular basis as a result of new standards, emerging auditing issues or implementation experiences.

Technology enablers — Numerous technology enablers are used by our audit teams to assist in executing and documenting the work performed in accordance with the Ernst & Young Global Audit Methodology.

Formation of audit teams — Ernst & Young requires an annual review of partner assignments for public companies by geographic operating region leadership and the National PPDs located in the geographic operating regions to make sure that the partners serving our public companies possess the appropriate competencies to fulfill their engagement responsibilities.

Policies for review and consultation

Reviews of audit work — Firm policies describe the requirements for timely, direct executive participation on audits and various levels of reviews of the work performed.

An independent look at all our audits — A professional and regulatory requirement for audits of public companies is that a partner independent of the audit team reviews the audit report on the financial statements (and where applicable the audit reports on internal controls over financial reporting) and performs certain other procedures prior to issuance of the report(s). We require such engagement quality reviews on all audits of both public and private companies.

Consultation requirements — The Engagement Partner (i.e., the Partner in charge of the audit) is ultimately responsible for determining that Ernst & Young reaches the appropriate answer on a technical accounting and auditing matter. The Engagement Partner has the authority and responsibility to respond to all technical questions related to the company's financial statements. Our consultation processes and related policies are designed to take advantage of all of the firm's resources in reaching our conclusions on complex and/or subjective accounting, auditing, reporting, SEC and independence matters. Consultation is a decision making process, not just a process to provide advice. For certain specified matters of significant sensitivity, Ernst & Young requires consultation outside of the audit team with other personnel who have more experience or knowledge, with the goal of deciding the appropriate position regarding these matters. We have a list of significant matters that require consultation on any engagement where the situation is encountered, and we supplement the list of required consultations to focus on emerging matters. In addition to matters where consultation is required, our people are encouraged to, and do, consult regularly on other significant accounting, auditing, reporting, SEC and independence matters, as well as on other sensitive issues or sensitive communications to companies we audit or others outside the firm.

Additional reports required under NYSE rules

Audit team disagreement resolution process – Ernst & Young has a collaborative culture and encourages its people to speak up if they disagree or are uncomfortable with an audit engagement matter. The firm's policies provide all of our people with the authority to demand a hearing for their views and an understanding that the firm considers all points of view when resolving key issues. When a matter that goes beyond the audit team is ultimately resolved, firm policies require it to be documented.

Internal accountability

Audit partner rotation – As required by the SEC's independence rules on audit engagements for public companies, our firm will rotate the lead audit partner, the engagement quality review partner (i.e., partner independent of the audit team) and other audit partners (as defined) no less frequently than the maximum years of service permitted by the SEC.

Conflicts resulting from employment relationships – Ernst & Young has policies and procedures to address the potential for actual or perceived impairment of independence for situations where the firm's professionals pursue or accept employment at one of the companies the firm audits. Our policies in this area address the SEC's cooling-off requirement, and set forth consultation protocols within the firm for certain job positions so that compliance is achieved with respect to both the letter and the spirit of the SEC's rules.

Partner evaluation and compensation methods – Ernst & Young evaluates and compensates its partners based on several factors that are aligned to the firm's overall strategy and direction. We do not compensate our audit partners on the sale or delivery of non-audit services to companies they audit. Our compensation approach reflects the firm's deep commitment to provide quality service as well as our professional obligation to maintain our independence.

Staff evaluations – Ernst & Young's performance management and development process is designed to provide timely, specific feedback on job performance. The purpose of the process is to help our people grow in their careers and to understand how their personal development is linked to the firm's values, strategy and overall success.

Client acceptance and continuance – Ernst & Young's audit acceptance process involves a careful consideration of the risk characteristics of a prospective entity and several due diligence procedures. Our approval process is rigorous, and no new audit entity may be accepted without the prior approval of the National PPDs located in the geographic operating regions. Additionally, as part of audit acceptance, an independence review is performed prior to accepting an initial engagement pursuant to the standards of the PCAOB. The National PPDs also are very involved in the continuance process and must be satisfied with the geographic operating region leadership's decisions. Both acceptance and continuance decisions depend on, among other things, the absence of any perception that a company's management pressures the audit team to accept inappropriate accounting and reporting. Our considerations and conclusions on the integrity of management are essential to our acceptance and continuance decisions.

Additional reports required under NYSE rules

Internal and external practice monitoring — Ernst & Young conducts an annual internal inspection program (Assurance Quality Review or AQR) that assesses the quality of our audit work for a cross-section of engagements. The objective of the AQR program is to evaluate the design and operating effectiveness of the firm's quality control policies and procedures for our accounting and auditing practice. The AQR program also aids our efforts to continue to identify areas where we can improve our performance or enhance our policies and procedures.

The PCAOB performs annual inspections of the firm's public company accounting and auditing practice and our non-public company practice is reviewed on a triennial basis as part of the AICPA peer review program.

People management

Recruitment and hiring — One of Ernst & Young's strategic objectives is to attract and build lifelong relationships with extraordinarily talented people. For the most part, the firm hires only candidates who have qualified academically to sit for the CPA examination in the state for which they are being recruited.

Professional development — Ernst & Young has requirements for continuing professional education that apply to all professionals. Our commitment to lifelong learning results in an improved ability to meet personal and professional goals and provide the highest quality service. An individual's professional development principally occurs through formal learning and on-the-job training. The core training courses are supplemented by training programs that are developed in response to changes in accounting and reporting standards, auditing standards and emerging practice issues.

Internal communications

Communication technology and knowledge databases — Ernst & Young makes significant investments in its knowledge and communications networks to assist our professionals. Examples of electronic mail communications and knowledge databases are: a regular newsletter that reports on the latest news and information about the firm and its services, a weekly newsletter that reports on recent accounting and auditing standard-setter activities and other important matters, and several intranet repositories providing information on important accounting, auditing and industry-related topics.

Appendix B

Report for Audit Committees: Information on Ernst & Young's Accounting and Auditing Practice

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

Background

Audit committees are required by the New York Stock Exchange (NYSE) listing standards to obtain, at least annually, a report from the independent auditors that describes any material issues raised by the most recent internal quality control review, peer review of the firm or any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with such issues. This report on the accounting and auditing practice of Ernst & Young LLP (EY or the firm) responds to this requirement. Professional standards require that we maintain the confidentiality of client information, and specifically we may not disclose any confidential client information without the consent of the client.

External practice monitoring

PCAOB inspections

In accordance with the Sarbanes-Oxley Act of 2002 (the Act), the Public Company Accounting Oversight Board (PCAOB) conducts inspections of registered public accounting firms to assess their compliance with the Act, the rules of the PCAOB and Securities and Exchange Commission (SEC) and professional standards relating to audits of SEC issuers. The Act requires that the Board issue a written report on each inspection and provides, in Section 1 04(g)(2), that "no portions of the inspection report that deal with criticisms of or potential defects in the quality control systems of the firm under inspection shall be made public if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report." This section of the report (Part II) has limited distribution to certain regulators.

The PCAOB posted its report on the 2011 Inspection of Ernst & Young LLP on its website on 21 December 2012. Members of the PCAOB's inspection staff conducted primary procedures for the 2011 inspection from April 2011 to November 2011. The 2011 inspection included a review of our processes, policies and procedures in certain areas at the National office and reviews of audit engagements at a number of our practice offices where the PCAOB inspection team reviewed our audit documentation, made inquiries of the audit engagement teams and performed other procedures. The PCAOB has not yet issued a report on the 2012 inspection of our firm, which is currently in process.

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

The publicly available sections of the PCAOB reports on the inspections of the firm through 2011 and our written responses were made available to you when the reports were issued and are also available on the PCAOB's website (www.pcaobus.org). The reports describe the procedures performed during the inspection and certain observations regarding audit performance. In the limited distribution section of its inspection reports, the PCAOB provided us with certain qualitative observations, primarily on our audit performance and certain elements of our quality controls. We have taken or are taking steps to address all of the matters described in the inspection reports. Our responses to Part II of the reports through 2008 have been accepted by the PCAOB without any matters being publicly disclosed. We submitted our responses to Part II of the 2009 and 2010 inspection reports in July 2011 and November 2012, respectively, and are waiting for the Board's determination on these submissions.

AICPA peer review

EY participates in the AICPA peer review program that requires a triennial review of our system of quality control for our non-SEC accounting and auditing practice. The AICPA peer review program serves as a bridge between the PCAOB's inspection program and the firm's state licensing and other federal regulatory practice monitoring requirements.

The most recent peer review of EY's non-SEC accounting and auditing practice was completed by KPMG for the year ended 30 June 2010. Under the peer review reporting model, firms can receive a rating of pass, pass with deficiency(ies) or fail. KPMG issued a report with a pass rating, dated 6 December 2010, in connection with our 2010 peer review. KPMG's 2010 report is available at your request.

Internal practice monitoring

EY conducts an annual internal inspection program (Assurance Quality Review or AQR) that assesses the quality of our audit work for a cross-section of audit engagements. The AQR program evaluates the design and operating effectiveness of the firm's quality control policies and procedures for our accounting and auditing practice. The AQR program also aids our efforts to continually identify areas where we can improve our performance or enhance our policies and procedures.

Based on the results of our 2012 internal inspection, we concluded that the system of quality control for our accounting and auditing practice has been designed and has operated in a manner that provides the firm with reasonable assurance of complying with professional standards. As always, we noted improvement opportunities for our accounting and auditing practice and have acted on them.

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

Governmental and professional inquiries and investigations

As is true of other national accounting firms, EY responds routinely to inquiries and investigations by the SEC and other governmental and professional bodies. A small number of these inquiries or investigations involve issues relating to the firm's compliance with auditing or other professional standards.

When we become aware of an investigation that raises issues about the firm's compliance with relevant standards, we conduct our own internal review of the matter (if we have not already done so). We typically review all relevant audit working papers and other documents, interview the appropriate personnel, research the relevant professional standards applicable to the engagement and perform any other necessary activities. Depending on the results of the internal or regulatory investigation, we determine what, if any, actions are appropriate to take with respect to the partner(s) and other members of the engagement team, the business unit in which they work or the firm's audit practice generally. For example, with respect to partners and other professionals, we consider whether it is appropriate to separate them from the firm, assign them to non-audit practices, preclude them from participating in audits of public companies, require extra supervision and monitoring of their work, require them to take additional training or be subject to other remedial measures. We also make determinations about whether we need to change our audit methodology, revise or develop new implementation guidance, add or modify training programs or take other actions at an office- or firm-wide level.

The following are matters where an allegation has been made or some type of sanction was entered against EY by a governmental or professional body:

PeopleSoft matter

In January 2008, the Washington State Board of Accountancy and the firm entered into an agreement resolving any issues that arose out of the Board's investigation relating to a 2004 SEC order entered in connection with an EY audit client, PeopleSoft, as well as another matter. Pursuant to the agreement, the firm provided the Board with information regarding enhancements to the firm's independence policies and procedures and also provided a webcast program on auditor independence that was offered for CPE credit to Washington licensees.

In June 2008, the New Mexico Public Accountancy Board and the firm entered into a settlement agreement resolving any issues relating to the Board's inquiry into the PeopleSoft matter. Under the terms of the agreement, the firm made a contribution to the New Mexico CPA Society.

In October 2008, the Pennsylvania Bureau of Professional and Occupational Affairs and the firm entered into a Stipulation for Withdrawal of Order to Show Cause pursuant to which, among other items, the firm agreed to provide a two-hour webcast on auditor independence for CPE credit to Pennsylvania licensees and to make a contribution to a community college in the Commonwealth of Pennsylvania.

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

Independence matter

In August 2008, the firm settled an SEC administrative proceeding involving EY and two of the firm's partners. The settlement related to an independence matter involving a consulting agreement that EY had with an individual from 2002 to 2004 who at the time was also a director of three audit clients. The SEC's Order stated that the consulting agreement violated the restriction on business relationships with audit clients.

The consulting agreement was entered into in 2002 during a time when EY did not have in place the improved and robust business relationship policies, processes, procedures and training that the firm currently has to help assess compliance with independence obligations. In the SEC's administrative order, the SEC acknowledges that "E&Y has significantly revised its independence policies and procedures. E&Y has also established a new business-relationship evaluation process for review and evaluation of both new and existing business relationships."

In April 2010, EY entered into a consent order with the Minnesota Board of Accountancy relating to this independence matter pursuant to which EY's permit was censured and reprimanded and the firm paid a $2,000 penalty. One of the audit clients was headquartered In Minnesota.

EY believes that independence is fundamental to its ability to serve as auditors and the firm remains committed to taking all appropriate steps to comply with applicable professional standards including those related to independence.

Bally Total Fitness matter

In December 2009, the SEC filed a settled administrative proceeding against EY relating to a former audit client, Bally Total Fitness (Bally), from which we resigned in 2004. EY neither admitted nor denied the SEC's allegations, none of which involved bad intent or reckless misconduct by EY or anyone at EY. The SEC's order stated that Bally's method of recognizing certain revenue was improper, and EY's audits of Bally's financial statements in 2001 through 2003 were deficient. In 2008, Bally settled an action brought by the SEC for fraud.

EY's settlement included a cease-and-desist order, a censure and a payment to the SEC of $8.5 million. The order also included undertakings requiring EY to adopt new procedures or enhance existing procedures relating to the consultation process with EY's National Professional Practice Office, the issuance of preferability letters and certain other matters. In addition to the action against EY, six EY partners (five now retired and one active) settled charges with the SEC; the individuals were not alleged to have acted with bad intent or recklessness. Neither the firm's settlement nor the settlements by the individual partners concerned accounting advice that the firm provided to any other clients. On 17 June 2010, EY's Chairman certified to the SEC Staff the firm's compliance with the undertakings. Pursuant to the SEC order, an outside consultant was engaged to verify EY's compliance; the consultant completed her work and concluded in a report to the SEC that EY had complied with the undertakings. We were also contacted by several state boards that subsequent to the SEC's order opened their own confidential investigations.

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

Medicis matter

In February 2012, the PCAOB announced a settled disciplinary order against EY relating to the 2005 through 2007 audits of Medicis Pharmaceutical Corporation. EY neither admitted nor denied the PCAOB's allegations, none of which involved bad intent or reckless misconduct by EY or anyone at EY. The PCAOB's order states that, during the relevant time period, EY violated PCAOB rules and auditing standards in connection with Medicis's accounting for product returns. Specifically, the order states that EY failed to evaluate properly Medicis's practice of reserving for most of its estimated product returns at the replacement cost of the product rather than the gross sales price. EY's settlement includes a censure and a payment to the PCAOB of $2 million. In addition to the action against EY, four of its current or former partners settled charges with the PCAOB; the individuals were not alleged to have acted with bad intent or recklessness.

EY has received inquiries from various state accountancy boards regarding this matter.

Lehman Brothers Holdings, Inc. bankruptcy

In September 2008, Lehman Brothers Holdings, Inc. (Lehman) filed for bankruptcy protection. Lehman's bankruptcy occurred in the midst of a global financial crisis triggered by dramatic increases in mortgage defaults, associated losses in mortgage and real estate portfolios and a severe tightening of liquidity. Like many major bankruptcies, Lehman's bankruptcy resulted in the appointment of a Bankruptcy Examiner and prompted numerous investigations; EY cooperated fully in those investigations. The role of an Examiner is to identify potential claims that may be pursued by creditors of the bankrupt entity. An Examiner's report does not represent the views of a court.

The Examiner's report, released to the public in March 2010, prompted the filing of numerous lawsuits against EY based on our role as Lehman's auditor. One of the complaints, filed in December 2010, was a civil claim by the New York State Attorney General (NYAG) alleging that EY's actions relating to Lehman constituted a violation of New York state's Martin Act.

No securities or accounting regulator has brought claims against EY or any of its professionals arising from our services as Lehman's independent auditors.

The focus in the various lawsuits is on Lehman's accounting and disclosures relating to certain sale and repurchase agreement transactions referred to as "Repo 105" transactions. We believe we have strong defenses both as to liability and damages with respect to all of the litigation instituted against EY, and we intend to vigorously defend against these claims. Most of the securities class action claims against EY were dismissed in 2011. As for the NYAG's claims, on 12 December 2012 the New York trial court granted EY's motion to dismiss the portion of the claim seeking "disgorgement" of fees earned by EY from Lehman for audit services; this constituted the NYAG's primary claim for damages. Lehman's audited financial statements (our last audit covered Lehman's fiscal year ended 30 November 2007) clearly portrayed the company as a highly leveraged entity operating a risky business in a volatile industry.

Report for Audit Committees:

Information on Ernst & Young's Accounting and Auditing Practice

SEC enforcement proceeding against China firms

In December 2012, the SEC instituted administrative proceedings against the Ernst & Young global network firm located in China, Ernst & Young Hua Ming LLP (EYHM), and against four other major accounting firms located in China. The complaint alleges that the China firms have "willfully violated" the federal securities laws by refusing to provide audit workpapers requested by the SEC's Enforcement Division as part of fraud investigations relating to several SEC registrants.

EYHM has informed the SEC that it has sought to comply and cooperate with the Enforcement Division but cannot do so without violating Chinese laws and the specific instructions of Chinese regulators. An SEC administrative law judge will hold a hearing involving the five firms and will determine the outcome including possible sanctions, subject to review by the Commission. While the matter is pending, EYHM can continue to perform audits of subsidiaries of SEC registrants located in China and can continue to render opinions on the financial statements of Chinese foreign private issuers. EY (the US member of the Ernst & Young global network) is not a party to this proceeding, but EY does rely on EYHM to perform audits of subsidiaries of SEC registrants in China. EY has urged the US and Chinese regulators to reach an agreement on information-sharing that will enable EYHM to comply with all applicable laws and regulations.

Ernst & Young
Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 167,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

About Ernst & Young's Assurance Services
Strong independent assurance provides a timely and constructive challenge to management, a robust and clear perspective to audit committees and critical information for investors and other stakeholders. The quality of our audit starts with our 60,000 assurance professionals, who have the experience of auditing many of the world's leading companies. We provide a consistent worldwide audit by assembling the right multidisciplinary team
to address the most complex issues, using a proven global methodology and deploying the latest, high-quality auditing
tools. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young
makes a difference.