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## **Item 3.2: Report on Audit Fieldwork and Conclusions**

*Deena Clausen*

Executive Director, Ernst & Young LLP (EY)

Finance & Audit Committee Meeting

ERCOT Public

April 13, 2015

# Electric Reliability Council of Texas, Inc.

## 2014 audit results

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April 13, 2015



Building a better  
working world



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

April 13, 2015

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 or the Council). This report also includes the status of our audit, which we anticipate will be completed on or about April 15, 2015. Open and candid dialogue with you, is a critical step in the audit process, and in the overall corporate governance process and we appreciate this opportunity to share the insights from our audit with you.

Our audit was designed to express an opinion on the 2014 financial statements as of December 31, 2014. We continue to receive the full support and assistance of ERCOT's personnel in conducting our audit.

At EY, we are committed to delivering the highest quality audit services, and we continually evaluate the quality of our professionals' work in order to meet or exceed your expectations.

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

We look forward to meeting with you to discuss the contents of this report and answer any questions you may have about these or any other audit-related matters.

Very truly yours,

Deena Clausen

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## 2014 EY services

### Services and deliverables

#### Audit and audit-related services

- Consistent with our audit plan, we express an opinion on, and report to the Finance and Audit Committee:
  - The financial statements of ERCOT
- Issue a written communication to:
  - Management and the Finance and Audit Committee describing significant deficiencies and material weaknesses identified during our audit, if identified
  - The Finance and Audit Committee about independence matters in accordance with AICPA AU-C Section 260, *The Auditor's Communication with Those Charged with Governance*
- Issue a management letter including recommendations for improvements in controls and procedures, if necessary

#### Tax services

- Provide tax compliance services for Form 990 federal tax filings

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# Executive summary

## Significant 2014 considerations\*

- 2014 audit results
- Market risk considerations

### Status

- The 2014 audit is progressing as planned. After completing our remaining procedures, we expect to issue an unqualified opinion on the financial statements.

### Scope

- Our audit scope is consistent with the plan communicated in April of 2014. We continually reassess the need for changes to our planned audit approach throughout the audit.

### Results

- The Council's analysis for significant accounting matters is appropriate.\*
- No corrected misstatements or material uncorrected misstatements were identified.\*

\* These matters are addressed on the following pages within our presentation.

### Open items

- Obtaining the executed letter of representations from management
- Fraud inquiries with those charged with governance and management (to be conducted at this meeting)
- Review of final financial statements
- Performance of subsequent event procedures through our opinion date
- Legal Letter responses
- One AR confirmation and one security deposit confirmation are outstanding

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## 2014 audit results

### Significant accounting policies

Provided below is a summary of the Council's significant accounting policies, which have been applied in accordance with US GAAP and consistent with industry practice:

Significant accounting policy/area of emphasis

#### **Systems under development**

The Council's approach and methodology for capitalizing both internal/external costs systems under development appear reasonable and were consistently applied.

We believe that the Council's system under development capitalization policy and the application thereof are appropriate. The Council concluded that all required disclosures for systems under development are included in the financial statements.

#### **Cash and restricted cash**

EY confirmed all cash and restricted cash accounts. Additionally, we confirmed all significant security deposit amounts at December 31, 2014.

#### **Revenue recognition**

EY tested the Council's revenue recognition of the System Admin Fee of \$158.7M and pass-through revenue of \$14.4M.

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## 2014 audit results

### Significant accounting policies

Significant accounting policy/area of emphasis

#### **Impairment of long-lived assets**

Management's policy for assessing the Council's assets for impairment is consistent with the prior year and is considered to be reasonable. Based on the results of our audit procedures, we agree there were no indicators of impairment during 2014.

#### **Regulatory assets and liabilities**

The Council defers revenues and costs under ASC 980 as the cost or obligation will be included in amounts allowable for recovery or refund in future rates.

ERCOT's approach and methodology for deferring revenues and costs 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, 2014. Amounts are properly stated and appropriate disclosures are made in the notes to the financial statements.



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## Uncorrected misstatements

### Uncorrected misstatements

Following is a summary of those misstatements we have identified through the date of this report that have not been corrected by the Council. These uncorrected misstatements, individually and in the aggregate, are not material to the Council's financial statements. We have considered the effect of these uncorrected misstatements on the prior year's financial statements and these misstatements did not cause us to change our conclusion on those financial statements.

Uncorrected misstatements		
Account	Amount	Description
• Depreciation expense	\$231,000	The Council did not properly place certain systems under development into service in 2013 so they recorded catch up depreciation expense in 2014 related to these assets.
• Prepaid expenses/accounts payable	\$112,000	As of December 31, 2014, the Council posted an adjustment in error to prepaid expenses and accounts payable.

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## Inquiries relating to matters relevant to the audit

We are making inquiries of you in our meeting with you in April 2014 related to fraud and other matters, that helped inform our audit strategy and the execution of our audit procedures. As a part of our upcoming meeting, we will update our inquiries of you to understand any other matters of which you believe we should be aware, including, but not limited to the following:

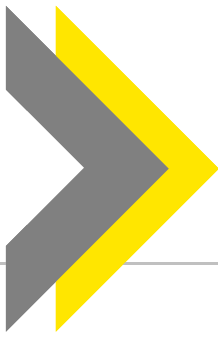
- Your views about the risks of material misstatements due to fraud, including the risks of management override of controls
- Your knowledge of any actual, alleged or suspected fraud
- Your awareness of tips or complaints regarding the Council's financial reporting (including those received through those charged with governance's own "whistleblower" program, if any) and its response to such tips and complaints
- How you exercise oversight over the Council's assessment of fraud risks and the establishment of controls to address these risks
- Your awareness of other matters, you believe, are relevant to the audit including, but not limited to, violations or possible violations of laws or regulations

When we identify a fraud risk, including a fraud risk that arises through or is associated with the risk of management override of controls, we perform audit procedures to address those risks. In addition to any specific responses related to the fraud risk, we also examine journal entries, review accounting estimates for management bias and evaluate the business rationale of significant unusual transactions as required by our professional standards.

# Supplements



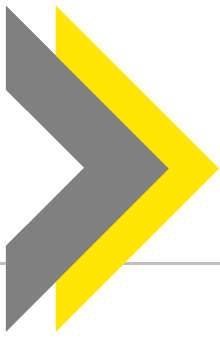
Required communications  
with those charged  
with governance



# Summary of required communications

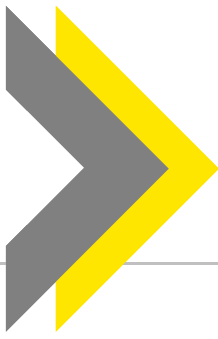
Provided below is a summary of required communications between the audit team and those charged with governance.

Services and deliverables	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:		
<ul style="list-style-type: none"> <li>Accounting policies</li> </ul>		X
<ul style="list-style-type: none"> <li>Additional views</li> </ul>		X
Uncorrected misstatements, related to accounts and disclosures, considered by management to be immaterial		X
Material corrected misstatements, related to accounts and disclosures		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	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	



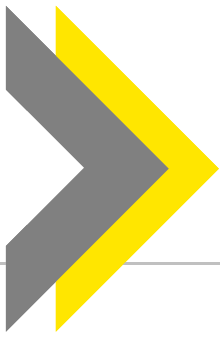
## Summary of required communications

Services and deliverables	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	



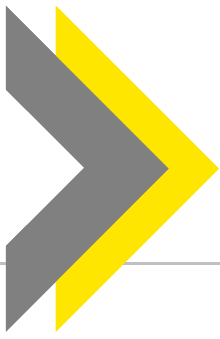
# Required communications

Area	Comments
<p>Overview of the planned scope and timing of the audit</p>	
<p>We provide those charged with governance with an overview of our overall audit scope, including the timing of the audit and our plans to use the work of internal auditors.</p>	<p>Our audit scope is consistent with the plan communicated during the April 2014 meeting.</p>
<p>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</p>	
<p>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.</p> <p>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.</p> <p>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.</p>	<p>Our responsibilities are included in our audit engagement agreement. A copy of such agreement has previously been provided to you.</p> <p>Upon completion of our remaining audit procedures, we currently expect to issue an unqualified opinion on the Council's financial statements as of and for the year ended December 31, 2014.</p>



# Required communications

Area	Comments
<p data-bbox="84 464 812 485">Our views about the qualitative aspects of the entity's significant accounting practices: accounting policies</p> <p data-bbox="84 512 756 680">As part of our discussion about the qualitative aspects of the entity's significant accounting practices, we discuss our views about the entity's application of accounting policies including instances we believe a significant accounting policy, although acceptable under US GAAP, is not appropriate for the particular circumstances of the entity.</p> <p data-bbox="84 695 571 722">Our discussion may also include the following:</p> <ul data-bbox="84 737 789 1199" style="list-style-type: none"><li data-bbox="84 737 789 814">• The initial selection of new, or changes in, significant accounting principles and policies, including the application of new accounting pronouncements.</li><li data-bbox="84 829 789 907">• The effect of the timing and method of adopting a change in accounting policy on current and future earnings of the entity (or expected new accounting pronouncements).</li><li data-bbox="84 921 789 978">• The appropriateness of the accounting policies to the particular circumstances of the entity.</li><li data-bbox="84 993 789 1104">• Where acceptable alternative accounting policies exist, the identification of financial statement items that are affected by the implemented significant policies as well as information on accounting policies used by similar entities.</li><li data-bbox="84 1119 789 1199">• The effect of a significant accounting policy in a controversial or emerging area (or those unique to an industry), particularly when there is a lack of authoritative guidance or consensus.</li></ul>	<p data-bbox="824 512 1523 590">Management has not selected or changed any significant accounting policies or changed the application of those policies in the current year.</p> <p data-bbox="824 604 1533 682">We are not aware of any significant accounting policies used by the Council in controversial or emerging areas or for which there is a lack of authoritative guidance.</p> <p data-bbox="824 697 1507 785">We have included a discussion of significant accounting policies within the section titled "Accounting policies and areas of emphasis" on pages 5 – 6.</p>



# Required communications

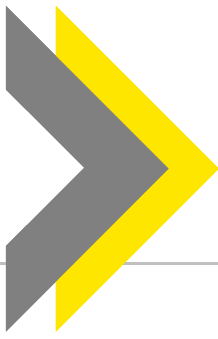
Area	Comments
Our views about the qualitative aspects of the entity's significant accounting practices: additional views	
<p>(1) Management's process used to develop particularly sensitive accounting estimates, our conclusions regarding the reasonableness of such estimates and the basis for those conclusions.</p> <p>Our discussion may also include the following:</p> <ul style="list-style-type: none"><li>• Risks of material misstatement</li><li>• Indicators of possible management bias</li><li>• Disclosure of estimation uncertainty in the financial statements</li></ul> <p>(2) Financial statement disclosures and related matters which may include the following:</p> <ul style="list-style-type: none"><li>• The issues involved and related judgments made, in formulating sensitive financial statement disclosures</li><li>• The overall neutrality, consistency and clarity of financial statement disclosures</li><li>• The potential effect of significant risks and exposures and uncertainties on the financial statements</li><li>• The extent to which the financial statements are affected by unusual transactions including nonrecurring amounts recognized</li><li>• The factors affecting asset and liability carrying value</li><li>• The selective correction of misstatements</li></ul> <p>(3) Significant unusual transactions (i.e., those outside the normal course of business for the entity or those that appear unusual due to timing, size, or nature) and the policies or practices management has used to account for those transactions.</p>	<p>We have provided our views regarding accounting estimates and financial statement disclosures and related matters in the sections titled "Accounting policies and areas of audit emphasis" on pages 5 and 6.</p>





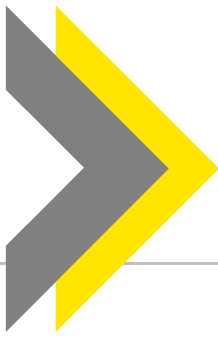
# Required communications

Area	Comments
<p data-bbox="82 459 829 483">Uncorrected misstatements, related to accounts and disclosures, considered by management to be immaterial</p> <p data-bbox="82 510 786 678">We discuss with those charged with governance uncorrected misstatements, related to accounts and disclosures, and the effect that they may have on our opinion in the auditor's report. We also discuss the effect of uncorrected misstatements related to prior periods on the significant classes of transactions, account balances or disclosures, and the financial statements as a whole.</p> <p data-bbox="82 693 781 833">In addition, we discuss with those charged with governance the implications of a failure to correct known and likely misstatements, if any, considering qualitative as well as quantitative considerations, including the possible implications in relation to future financial statements.</p>	<p data-bbox="829 510 1528 623">Refer to "Uncorrected misstatements" section on page 7. The schedule of uncorrected misstatements was provided to management and will be included as an attachment to the letter of representation.</p>
<p data-bbox="82 852 557 873">Material corrected misstatements, related to accounts and disclosures</p> <p data-bbox="82 903 786 1098">We discuss with those charged with governance material, corrected misstatements, related to accounts and disclosures, that were brought to the attention of management as a result of our audit procedures. In addition, we may discuss other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.</p>	<p data-bbox="829 903 1528 984">No corrected misstatements were identified in connection with our audit of the Council's financial statements as of and for the year ended December 31, 2014.</p>
<p data-bbox="82 1119 540 1140">Significant deficiencies and material weaknesses in internal control</p> <p data-bbox="82 1169 748 1278">We communicate all significant deficiencies and material weaknesses in internal control that were identified during the course of our audit, including those that have been remediated during the audit.</p>	<p data-bbox="829 1169 870 1192">N/A</p>



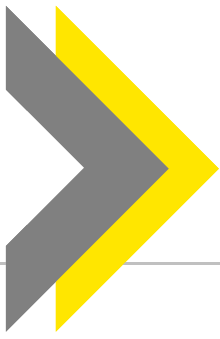
# Required communications

Area	Comments
<p>Our responsibility, any procedures performed and the results relating to other information in documents containing audited financial statements</p>	
<p>Our auditor's report on the financial statements relates only to the financial statements and the accompanying notes. If the entity includes other information in documents containing audited financial statements, we review such other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the audited financial statements. If we conclude that a material inconsistency exists, we determine whether the financial statements, our auditor's report, or both require revision. In addition, we notify you if we conclude that there is a material misstatement of fact in the other information.</p>	<p>N/A</p>
<p>Fraud and illegal acts</p>	
<p>We communicate with those charged with governance fraud and illegal acts involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements.</p> <p>If desired by those charged with governance or we determine it is appropriate, we communicate to those charged with governance regarding fraud involving employees other than management that does not result in a material misstatement.</p> <p>We also communicate other matters of non-compliance with laws and regulations (illegal acts) that come to our attention during the audit, unless they are clearly inconsequential.</p>	<p>We are not aware of any matters that require communication.</p>
<p>Independence matters</p>	
<p>Although the auditor's report affirms our independence, in certain situations, we discuss with those charged with governance circumstances of relationships (e.g., financial interests, business or family relationships, or non-audit services provided or expected to be provided) that in our professional judgment may reasonably be thought to bear on independence and that we gave significant consideration to in reaching the conclusion that independence has not been impaired.</p>	<p>We are not aware of any matters that in our professional judgment would impair our independence.</p>



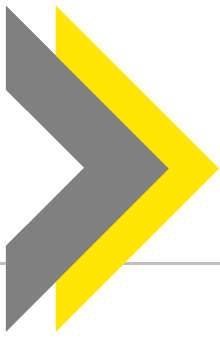
# Required communications

Area	Comments
<p>Representations we are requesting from management</p>	
<p>We discuss with those charged with governance representations we are requesting from management.</p>	<p>We will obtain from management a letter of representations related to the audit.</p>
<p>Changes to the terms of the audit with no reasonable justification for the change</p>	
<p>We discuss with those charged with governance any changes to the terms of the audit engagement where there is no reasonable justification for the change and we are not permitted by management to continue the original audit.</p>	<p>None.</p>
<p>Significant findings and issues arising during the audit relating to related parties</p>	
<p>We discuss with those charged with governance any significant findings and issues arising during the audit relating to the entity's related parties. Such matters may include the following:</p> <ul style="list-style-type: none"> <li>• Non-disclosure (whether intentional or not) by management of related parties or significant related party transactions</li> <li>• The identification of significant related party transactions that have not been appropriately authorized and approved</li> <li>• Disagreement with management regarding the accounting for, and disclosure of, significant related party transactions in accordance with US GAAP</li> <li>• Non-compliance with applicable law or regulations prohibiting or restricting specific types of related party transactions</li> <li>• Difficulties in identifying the party that ultimately controls the entity</li> </ul>	<p>None.</p>
<p>Significant findings or issues, if any, arising from the audit that were discussed, or the subject of correspondence, with management</p>	
<p>We discuss with those charged with governance any significant matters that were discussed with, or the subject of correspondence with, management, including:</p> <ul style="list-style-type: none"> <li>• Business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatements.</li> <li>• Discussions or correspondence in connection with our initial or recurring retention as the auditor, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, the scope of the audit, financial statement disclosures and the wording of the auditor's report. We communicate those major professional issues we discussed with management, prior to our being hired as the auditors, during the entity's two most recently completed fiscal years and any subsequent interim period.</li> </ul>	<p>None.</p>



# Required communications

Area	Comments
<p>Significant difficulties encountered during the audit</p> <p>We inform those charged with governance of any significant difficulties encountered in dealing with management related to the performance of the audit which may include such matters as:</p> <ul style="list-style-type: none"><li>• Significant delays in management providing required information</li><li>• An unnecessarily brief time within which to complete the audit</li><li>• The unavailability of expected information</li><li>• Restrictions imposed on us by management</li><li>• Management's unwillingness to provide information about its plans for dealing with the adverse effects of the conditions or events that lead us to believe there is substantial doubt about the entity's ability to continue as a going concern</li></ul>	<p>None.</p>
<p>Disagreements with management</p> <p>We discuss with those charged with governance any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or our auditor's report. For purposes of this discussion, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved.</p>	<p>None.</p>
<p>Management's consultations with other accountants</p> <p>When we are aware that management has consulted with other accountants about accounting or auditing matters, we discuss with those charged with governance our views about significant matters that were the subject of such consultation.</p>	<p>None of which we are aware.</p>
<p>Findings regarding external confirmations</p> <p>We discuss with those charged with governance any instances where management has not permitted us to send confirmation requests, or where we cannot obtain relevant and reliable audit evidence from alternative procedures.</p>	<p>None.</p>



## Required communications

Area	Comments
<p>AICPA ethics ruling regarding third-party service providers</p> <p>AICPA Ethics Ruling No. 112 under Rule 102, <i>Integrity and Objectivity</i>, requires that we inform you whenever we use a third-party service provider in providing professional services to the entity. The Rule has broadly defined “third-party service provider” to include an individual who is not employed by our US firm. Accordingly, third-party service providers might include, but not be limited to, the following examples: non US personnel who work for EY affiliate firms (e.g., Ernst &amp; Young United Kingdom), non US personnel working in the US on a foreign secondment and non US personnel working at EY shared service centers.</p>	<p>From time to time, and depending on the circumstances, (1) we may subcontract portions of the Audit Services to other EY firms, who may deal with the Council or its affiliates directly, although EY alone will remain responsible to you for the Audit Services, and (2) personnel (including non- certified public accountants) from an affiliate of EY or another EY 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 EY in connection with the Audit Services.</p>
<p>Other findings or issues regarding the oversight of the financial reporting process</p> <p>We communicate other findings or issues, if any, arising from the audit that are, in our professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.</p>	<p>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.</p>

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**About EY**

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

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Our assurance services help our clients meet their reporting requirements by providing an objective and independent examination of the financial statements that are provided to investors and other stakeholders. Throughout the audit process, our teams provide timely and constructive challenge to management on accounting and reporting matters and a robust and clear perspective to audit committees charged with oversight.

The quality of our audit starts with our 60,000 assurance professionals, who have the breadth of experience and on-going professional development that comes from auditing many of the world's leading companies.

For every client, we assemble the right multidisciplinary team with the sector knowledge and subject-matter expertise to address your specific issues. All teams use our Global Audit Methodology and latest audit tools to deliver consistent audits worldwide.