

**IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S.5, AS AMENDED**

- and -

IN THE MATTER OF ERNST & YOUNG LLP

- and -

**IN THE MATTER OF ERNST & YOUNG LLP
(AUDITS OF ZUNGUI HAIXI CORPORATION)**

**SETTLEMENT AGREEMENT
BETWEEN STAFF OF THE COMMISSION
AND ERNST & YOUNG LLP**

PART I — INTRODUCTION

1. The Ontario Securities Commission (the "Commission") will issue a Notice of Hearing to announce that it will hold a hearing to consider whether, pursuant to sections 127 and 127.1 of the *Securities Act*, R.S.O. 1990, c. S-5, as amended (the "*Securities Act*"), it is in the public interest for the Commission to make certain orders in respect of Ernst & Young LLP ("Ernst & Young").

PART II - JOINT SETTLEMENT RECOMMENDATION

2. Staff of the Commission ("Staff") and Ernst & Young have agreed to a settlement of the proceeding initiated in respect of Ernst & Young by Notice of Hearing dated December 3, 2012 (the "Sino-Forest Proceeding") relating to its audits of the financial statements of Sino-Forest Corporation ("Sino-Forest"), and of the proceeding initiated in respect of Ernst & Young by Notice of Hearing dated June 24, 2013 (the "Zungui Proceeding") relating to its audits of the financial statements of Zungui Haixi Corporation ("Zungui") on the basis of the terms and conditions set out in this settlement agreement ("Settlement Agreement").

3. Pursuant to the Settlement Agreement, Staff agree to recommend to the Commission that the Sino-Forest Proceeding and the Zungui Proceeding (collectively the “Proceedings”) be resolved and disposed of in accordance with the terms and conditions contained in this Settlement Agreement.

4. It is Staff’s position that:

- a. the statement of facts set out by Staff in Part III below, which is based on investigations carried out by Staff regarding Ernst & Young’s audits of the financial statements of Sino-Forest and Zungui, is supported by the evidence reviewed by Staff and the conclusions contained in Part III are reasonable; and
- b. it is in the public interest for the Commission to approve this Settlement Agreement, having regard to the following considerations:
 - i. Staff’s core allegation in each of the Proceedings is that Ernst & Young failed to conduct audits of year-end financial statements of a reporting issuer operating in the People’s Republic of China (“the PRC”) in accordance with generally accepted auditing standards (“GAAS”), resulting in breaches of the *Securities Act*;
 - ii. Staff do not allege, and have found no evidence of, dishonest conduct by Ernst & Young;
 - iii. During Staff’s investigation of Sino-Forest, Ernst & Young produced preliminary documents without a summons and witnesses for examination from outside the jurisdiction. In Zungui, Ernst & Young co-operated by providing Staff with an affidavit sworn by one of its partners. Further, it was through Ernst & Young’s escalation of its concerns to Zungui’s Audit Committee in August 2011 during the audit of Zungui’s 2011 financial statements that its financial reporting irregularities came to light;

- iv. Subsequent to the events at issue, the Commission published OSC Staff Notice 51-719–*Emerging Markets Issuer Review* (the “EMIR Report”) and OSC Staff Notice 51-720–*Issuer Guide for Companies Operating in Emerging Markets* (the “Guide”), providing guidance and recommendations concerning governance and disclosure practices for issuers with significant operations in emerging markets and their advisors;
- v. Ernst & Young settled class action lawsuits relating to its audits of the financial statements of Sino-Forest before the Ontario Superior Court of Justice (the “Ontario Court”), Quebec Superior Court (the “Quebec Court”) and United States District Court for the Southern District of New York (the “U.S. Court”) and relating to its audits of the financial statements of Zungui before the Ontario Court by paying a total of \$119 million to shareholders and noteholders of Sino-Forest and shareholders of Zungui. The settlements were found by the respective Courts adjudicating upon them to be fair and reasonable;
- vi. The hearing in the Sino-Forest Proceeding is scheduled to commence on November 11, 2014 and the hearing in the Zungui Proceeding is scheduled to commence on May 1, 2015.
- vii. Settlement of the Proceedings will avoid two complex and lengthy hearings dealing with the interpretation and application of auditing standards in connection with audits of financial statements of reporting issuers, the exercise of professional judgment and the conflicting reports of multiple expert witnesses;
- viii. Ernst & Young has advised Staff that since 2011, as part of its ongoing process to improve audit policies and procedures in response to the changing business environment, new standards, and current practice developments, Ernst & Young has implemented

enhancements in its policies and procedures for auditing companies with significant operations in emerging markets and its client continuance and acceptance processes, and has made significant ongoing investments in its audit quality support structures;

- ix. Ernst & Young has also advised Staff that after the events at issue, it conducted a focussed assessment of its audits of entities with principal operations in the PRC. For in-progress or continuing audits, Ernst & Young dedicated additional resources as appropriate to address the heightened risks, and in other instances discontinued as auditor;
- x. Ernst & Young has agreed to make a voluntary payment of \$8 million to the Commission to advance the Commission's mandate of protecting investors and fostering fair and efficient capital markets.
- xi. Ernst & Young will pay the agreed settlement amount of \$8 million by wire transfer before the commencement of the hearing before the Commission to approve this Settlement Agreement, which payment is conditional upon approval of the Settlement Agreement by the Commission.
- xii. The terms of settlement are appropriate in all the circumstances including mitigating factors and the principles of general and specific deterrence.

5. Ernst & Young neither admits nor denies the accuracy of the facts or the conclusions of Staff as set out in Part III of this Settlement Agreement.

6. Ernst & Young agrees to this Settlement Agreement and consents to the making of an order in the form attached as Schedule "A".

PART III — STAFF’S STATEMENT OF FACTS AND CONCLUSIONS

A. Overview

Sino-Forest Corporation

7. Ernst & Young were the auditors of Sino-Forest between August 2007 and April 2012. During that time, they audited the consolidated financial statements of Sino-Forest as at and for its fiscal years ended December 31, 2007, December 31, 2008, December 31, 2009 and December 31, 2010 (respectively, the “2007 Financial Statements”, the “2008 Financial Statements”, the “2009 Financial Statements” and the “2010 Financial Statements” and collectively the “Material Financial Statements”) and represented to its shareholders that they had performed their audits in accordance with GAAS.

8. GAAS requires an auditor to obtain sufficient appropriate audit evidence to obtain reasonable assurance that the financial statements subject to audit are not materially misstated.

9. Ernst & Young did not obtain sufficient appropriate audit evidence with respect to the ownership and existence of the BVI Standing Timber Assets, defined below, recorded in the Material Financial Statements.

10. Ernst & Young did not exercise sufficient professional skepticism when executing and evaluating the audit procedures with respect to the BVI Standing Timber Assets.

11. Consequently, Ernst & Young did not comply with GAAS by failing to obtain reasonable assurance that the Material Financial Statements were not materially misstated as it did not obtain sufficient appropriate audit evidence with respect to the ownership and existence of the BVI Standing Timber Assets.

Zungui Haixi Corporation

12. On December 21, 2009, Zungui completed an initial public offering, ultimately raising \$39.8 million in total gross proceeds from investors (the “IPO”). Its shares were listed for trading on the TSX Venture Exchange. In preparation for the IPO, Ernst &

Young audited Zungui's consolidated financial statements (the "IPO Audit") and issued an auditor's report stating that it had performed the audit in accordance with GAAS.

13. During the course of the IPO Audit, Ernst & Young :
 - a. identified a risk that Zungui could use fictitious distributors to fraudulently inflate its revenue, but then disregarded evidence suggesting that the company may have exaggerated its sales to distributors;
 - b. noted that Zungui's management had an incentive to manipulate the company's financial results to attract investors for the IPO, but failed to consider evidence that indicated inconsistencies in the company's revenue and earnings with appropriate skepticism; and
 - c. failed to conduct a sufficient review of the audit evidence.

14. Ernst & Young also conducted an audit of Zungui's financial statements for its 2010 fiscal year (the "2010 Audit") and issued an auditor's report stating that it had performed the audit in accordance with GAAS. Ernst & Young, however, also failed to conduct the 2010 Audit in accordance with GAAS, as it contained several of the same deficiencies as the IPO Audit.

B. Generally Accepted Auditing Standards

15. The objective of an audit of an entity's financial statements is to express an opinion on whether the financial statements present fairly, in all material respects, the financial position, results of operations and cash flows of the entity in accordance with generally accepted accounting principles. Such an opinion is not an assurance as to the future viability of an entity nor an opinion as to the efficiency or effectiveness with which its operations, including internal control, have been conducted.

16. In the performance of an audit of financial statements, the auditor must comply with GAAS regarding the performance of the audit and the preparation of their report.

17. An audit conducted in accordance with GAAS requires that an auditor plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement.

18. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

19. The auditor seeks reasonable assurance, which is a high, though not absolute, level of assurance, that the financial statements are free of material misstatement, whether caused by fraud or error.

20. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole.

21. Reasonable assurance relates to the whole audit process. An auditor cannot obtain absolute assurance because there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements.

22. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level of risk of material misstatement in the financial statements. In developing its opinion, the auditor considers all relevant audit evidence, regardless of whether it appears to corroborate or contradict the assertions in the financial statements.

23. The sufficiency and appropriateness of audit evidence to support the auditor's conclusions throughout the audit are a matter of professional judgment influenced by a number of factors. Sufficiency is the measure of the quantity of the audit evidence. Appropriateness is the measure of the quality of audit evidence.

24. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality

of such audit evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of audit evidence are interrelated. However, merely obtaining more audit evidence may not compensate for its poor quality.

25. An auditor is required to plan and perform an audit with an attitude of professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. The auditor should make a critical assessment, with a questioning mind, of the sufficiency and appropriateness of the audit evidence obtained, and should be alert for evidence that contradicts or brings into question the reliability of documents or representations of management or those charged with governance.

26. Professional skepticism includes being alert to, for example:

- a. audit evidence that contradicts other audit evidence obtained;
- b. information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence;
- c. conditions that may indicate possible fraud; and
- d. circumstances that suggest the need for additional audit procedures.

27. GAAS makes clear that the detection of a material misstatement resulting from fraud is less likely if it involves sophisticated and carefully organized schemes to conceal it. Such attempts at concealment may be even more difficult to detect when accompanied by collusion.

C. Audits of Sino-Forest Corporation

Background

28. Sino-Forest was a reporting issuer in the province of Ontario as that term is defined in subsection 1(1) of the *Securities Act*. The majority of Sino-Forest's reported business involved the purchase and sale of trees in the PRC, which were categorized on

its balance sheet as “Timber Holdings” and commonly referred to as “Standing Timber”. During the material time and until May 9, 2012, the common shares of Sino-Forest were listed and posted for trading on the Toronto Stock Exchange.

29. Ernst & Young is a firm of chartered accountants with a head office located in Toronto, Ontario. It has offices located across Canada.

30. Ernst & Young was appointed as the auditor of Sino-Forest on August 16, 2007. Ernst & Young audited the Material Financial Statements.

31. Shareholders invested significant sums in Sino-Forest in reliance on the Material Financial Statements.

32. Between February 2003 and October 2010, Sino-Forest raised approximately US \$3.0 billion through the issuance of equity and debt securities to investors.

33. Between June 30, 2006 and March 31, 2011, Sino-Forest’s share price increased from \$5.75 to \$25.30, an increase of 340%. By March 31, 2011 Sino-Forest’s market capitalization was well over \$6.0 billion.

34. On June 2, 2011, the share price of Sino-Forest fell after the publication of allegations of fraud against Sino-Forest. On the same day, the Board of Directors of Sino-Forest established an Independent Committee (the “IC”) to conduct forensic procedures and to independently examine and review the “serious and wide-ranging allegations” made in the analyst’s report.

35. The IC identified a number of areas of Sino-Forest’s business for investigation, including its ownership of trees and the existence of those trees. The IC prepared and released three reports concerning its findings, dated August 10, 2011, November 13, 2011 and January 31, 2012 (the “IC Reports”).

36. In the IC Reports, the IC presented its findings regarding the ownership and existence of Standing Timber. The IC reported that it was able to reconstruct the accounting records for the recorded Standing Timber but was unable to verify registered title to a significant proportion of them. The IC found that as at December 31, 2010,

Sino-Forest had registered title to approximately 17.9% of its Standing Timber and contractual or other rights to another 81.3%. In addition, the IC noted significant obstacles to verifying the actual existence of the reported Standing Timber, including an inability to identify the precise location of the trees which had reportedly been purchased by Sino-Forest. Citing an agreement with Sino-Forest's noteholders and diminishing returns, the IC ceased its work on January 31, 2012.

37. Sino-Forest filed interim financial statements with the Commission for the first two quarters of 2011. Ernst & Young was initially engaged to conduct a review of these interim financial statements. Ernst & Young did not complete its review of the Q1 2011 interim financial statements and did not undertake a review of the Q2 2011 interim financial statements. On November 15, 2011, Sino-Forest announced that it would defer the release of its interim filing for the third quarter of 2011. That filing has not been made.

38. On January 10, 2012, Sino-Forest issued a press release cautioning that its historic financial statements and related audit reports should not be relied upon.

39. Sino-Forest was required to file its consolidated financial statements for the year ended December 31, 2011 (the "2011 Financial Statements") with the Commission by March 30, 2012. On that day, Sino-Forest initiated proceedings in the Ontario Court requesting protection from its creditors under the *Companies Creditors Arrangement Act*, R.S.C. 1985, c. C-36. Sino-Forest has not filed the 2011 Financial Statements with the Commission.

40. On April 4, 2012, Ernst & Young resigned as the auditor of Sino-Forest. In the Change of Auditor Notice dated April 13, 2012, Sino-Forest repeated its caution that its historic financial statements and related audit reports should not be relied upon.

41. On May 22, 2012, Staff issued a Statement of Allegations naming Sino-Forest and six members of its executive management team. Staff allege that five of the named members of Sino-Forest's executive management team, including the Chairman and Chief Executive Officer:

- a. engaged in a complex fraudulent scheme to inflate the assets and revenue of Sino-Forest;
- b. made materially misleading statements in Sino-Forest's public disclosure record related to its primary business;
- c. concealed Sino-Forest's control over suppliers, customers and other nominee companies in the network of wholly owned subsidiaries of Sino-Forest incorporated in the British Virgin Islands ("BVI Subsidiaries");
- d. falsified the evidence of ownership for the vast majority of its Standing Timber by engaging in a deceitful documentation process;
- e. concealed internal control weaknesses/failures that obscured the true nature of transactions conducted within the network of BVI Subsidiaries and prevented the detection of the deceitful documentation process; and
- f. did not make Ernst & Young aware of Sino-Forest's "systematic practice of creating deceitful Purchase Contracts and Sales Contracts, including key attachments to these contracts".

The Business of Sino-Forest Corporation

42. Sino-Forest disclosed that Standing Timber was purchased, held and sold by Sino-Forest through two distinct legal structures or models: the British Virgin Islands Model (the "BVI Model") and the Wholly Foreign-Owned Enterprises Model (the "WFOE Model"). In the BVI Model, Sino-Forest's purchases and sales of Standing Timber were principally conducted using BVI Subsidiaries. The BVI Subsidiaries entered into written purchase contracts with suppliers located in the PRC (the "Purchase Contracts") and then entered into written sales contracts with customers called "authorized intermediaries" also located in the PRC (the "Sales Contracts").

43. The vast majority of Sino-Forest's assets were held in the BVI Model, which produced nearly all of its reported revenue.

44. At December 31, 2010, Sino-Forest reported total Timber Holdings of US \$3.1 billion comprising 799,700 hectares. Approximately US \$2.5 billion or approximately 80% of the total value of the Timber Holdings were recorded as held in the BVI Model (the “BVI Standing Timber Assets”), comprising approximately 467,000 hectares of Standing Timber.

45. Between 2007 and 2010, reported revenue from the BVI Model totalled US \$3.35 billion, representing 94% of Sino-Forest’s reported Standing Timber revenue and 70% of Sino-Forest’s total revenue. The significance of the revenue from the BVI Model is demonstrated in the following table:

	<i>US \$ (millions)</i>				
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>Total</u>
BVI Model Revenue	501.4	644.9	882.1	1,326.0	3,354.4
WFOE Model Revenue	20.1	40.5	72.1	75.2	207.9
Standing Timber Revenue	521.5	685.4	954.2	1,401.2	3,562.3
Total Revenue	713.9	896.0	1,238.2	1,923.5	4,771.6
BVI Model as % of Total Revenue	70%	72%	71%	69%	70%

Ernst & Young’s Obligations as Auditor

46. As a reporting issuer, Sino-Forest was required by subsection 78(1) of the *Securities Act* to file its annual consolidated financial statements with the Commission. Sino-Forest filed its 2007 Financial Statements on March 18, 2008, its 2008 Financial Statements on March 16, 2009, its 2009 Financial Statements on March 16, 2010 and its 2010 Financial Statements on March 15, 2011.

47. As the auditor of a reporting issuer, Ernst & Young was required by section 3.2 of National Instrument 52-107–*Acceptable Accounting Principles and Auditing Standards* (“National Instrument 52-107”), and by subsections 78(2) and 78(3) of the *Securities Act*, to audit the Material Financial Statements in accordance with Canadian GAAS and to prepare auditor’s reports to accompany the Material Financial Statements.

48. Each of the Material Financial Statements was accompanied by an auditor's report, prepared by Ernst & Young, addressed to the shareholders of Sino-Forest (the "Auditor's Report"). In each Auditor's Report, Ernst & Young stated that it had conducted its audits in accordance with GAAS. The Auditor's Reports relating to the Material Financial Statements were dated March 12, 2008, March 13, 2009, March 15, 2010 and March 14, 2011 and were filed by Sino-Forest with the Commission along with the Material Financial Statements.

49. Sino-Forest filed two short form prospectuses with the Commission dated June 1, 2009 and December 10, 2009 (the "Short Form Prospectuses"). The Short Form Prospectuses incorporated by reference the 2008 Financial Statements accompanied by the relevant Auditor's Report. In letters addressed to and filed with the Commission by Sino-Forest along with the Short Form Prospectuses, Ernst & Young consented to the incorporation of its Auditor's Report by reference in Sino-Forest's Short Form Prospectuses and further stated that it had no reason to believe that there were any misrepresentations in the information contained in the Short Form Prospectuses derived from the financial statements upon which Ernst & Young had reported or that were within its knowledge as a result of the audits.

Ernst & Young's Failures to Meet Generally Accepted Auditing Standards

50. In the audits of the Material Financial Statements, in addition to what is described herein, Ernst & Young planned and performed various audit procedures and obtained audit evidence with respect to Sino-Forest's ownership and the existence of the BVI Standing Timber Assets.

51. However, Ernst & Young did not obtain sufficient appropriate audit evidence with respect to the ownership and existence of the BVI Standing Timber Assets recorded in the Material Financial Statements. Ernst & Young did not exercise sufficient professional skepticism when executing and evaluating the audit procedures applied to the BVI Standing Timber Assets.

52. Consequently, Ernst & Young did not comply with GAAS by failing to obtain reasonable assurance that the Material Financial Statements were not materially misstated as it did not obtain sufficient appropriate audit evidence with respect to the ownership and existence of the BVI Standing Timber Assets.

Ownership of Standing Timber

53. The audit procedures performed by, and the audit evidence obtained by Ernst & Young with respect to Sino-Forest's ownership of the BVI Standing Timber Assets, were deficient in a number of respects, as outlined below.

(a) Purchase Contracts

54. One of the audit procedures that Ernst & Young performed relating to the ownership of the BVI Standing Timber Assets was to vouch all purchase transactions to the underlying Purchase Contracts and associated survey reports and forestry bureau confirmations ("Confirmations") for each fiscal year that it audited. Ernst & Young understood that all of Sino-Forest's Purchase Contracts had been prepared by Sino-Forest from a common template.

55. The Purchase Contracts referred to four appendices, titled Stock Volume Report, Resources-Quality Survey Report, Villagers' Letter of Authorization and Decision ("Villagers' Letters") and Certificate of Forest Proprietorship ("Certificates").

56. Villagers' Letters authorized the seller to sell the timber rights set out in the Purchase Contract. Certificates reflected the contents of the official PRC government registers concerning ownership of the rights to the relevant timber. Those two documents were not attached to the Purchase Contracts received by Ernst & Young. Ernst & Young did not inquire about their unavailability nor document in the audit files why they were not available from Sino-Forest.

57. In addition, the physical location of the BVI Standing Timber Assets was not clearly delineated in either the Purchase Contract or any of its available appendices.

58. Both of these issues should have prompted Ernst & Young to make further inquiries of Sino-Forest management and to perform further audit procedures relating to Sino-Forest's ownership of the BVI Standing Timber Assets.

(b) Legal Opinions

59. During the audit of the 2007 Financial Statements, Ernst & Young asked Sino-Forest to obtain a legal opinion prepared by Jingtian & Gongcheng Attorneys at Law ("Jingtian"), Sino-Forest's corporate counsel located in the PRC. Ernst & Young selected a representative Purchase Contract that was sent to Jingtian for its review for the purposes of its opinion. Jingtian acknowledged that its opinion dated March 10, 2008 addressed to Sino-Forest (the "Jingtian Opinion") was being provided to Ernst & Young.

60. The Jingtian Opinion discussed the legal regime relating to forestry assets located in the PRC and evaluated the nature and status of Sino-Forest's legal claim to ownership of the BVI Standing Timber Assets.

61. The Jingtian Opinion discussed the status of Certificates in the PRC legal regime. It noted that the PRC forestry authorities were reporting significant delays and backlogs in the production of a new form of these Certificates. The Jingtian Opinion stated that Jingtian had not reviewed the Villagers' Letters or Certificates.

62. Jingtian also stated that pending availability of the new Certificates, Confirmations were valid documents issued by relevant government authorities in the PRC evidencing ownership.

63. The Jingtian Opinion indicated that in 2002 the PRC authorities had predicted that the new Certificates would become available beginning in approximately 2004, but did not explain why the new Certificates were not available as of 2008.

64. Ernst & Young did not consider whether there were limitations in the Jingtian Opinion that would reduce its quality as audit evidence. In particular, Ernst & Young did not consider and respond to:

- a. the fact that it had never obtained copies of Villagers' Letters or Certificates for any Purchase Contract;
- b. the implications of the statement contained in the Jingtian Opinion that Villagers' Letters and Certificates had not been reviewed by Jingtian; and
- c. the reason for the continued unavailability of the new Certificates.

65. Ernst & Young continued to rely upon the Jingtian Opinion for the audits of the 2008, 2009 and 2010 Financial Statements and did not require that it be updated. During the audits, Ernst & Young did not further inquire as to why the new Certificates were not available as at 2008 or at any time thereafter. Instead Ernst & Young obtained from Sino-Forest opinion letters issued by Jingtian in the context of public offerings and relied upon them as audit evidence for ownership and existence in each of those subsequent years.

Existence of Standing Timber

66. Ernst & Young recognized that several aspects of Sino-Forest's business resulted in higher inherent risks relating to the existence of the BVI Standing Timber Assets. However, Ernst & Young failed to adequately respond to these risks.

67. In particular, Sino-Forest did not make direct cash payments for the acquisition of the BVI Standing Timber Assets. Rather, the payments that Sino-Forest should have received from its customers were immediately applied towards the purported purchase of further timber assets. This increased the risks surrounding the audit of the Purchase Contracts as there were no cash transfers that could be traced and verified.

(a) Pöyry Site Visits

68. Ernst & Young understood from Pöyry Forest Industry Ltd. ("Pöyry") and its reports that all of its visits included specific site and tree verification, the objective of which was to establish on a sample basis the characteristics of the forest species, age and location used for the valuation of Standing Timber owned by Sino-Forest.

69. In each audit year, Ernst & Young attended with Pöyry staff during at least one of Pöyry's plantation site visits. Each of these visits was to a different plantation site. During these visits, Ernst & Young staff observed Pöyry staff's measurement and verification activities.

70. Ernst & Young relied upon, but was not involved in Pöyry's process of selecting which plantations to sample, its determination of the location of the sampled plantations and its counting and measurement of the trees.

71. The limited number of site visits made by Ernst & Young to the plantations, which were widely scattered throughout the PRC, and the procedures performed by it in connection with those visits were insufficient and inappropriate to respond to the identified risks.

72. Although Ernst & Young verified that the forest resources valued by Pöyry matched, on an aggregate basis, Sino-Forest's underlying accounting records, Ernst & Young failed to perform any independent audit procedures to ensure that the plantations visited by Pöyry were owned by Sino-Forest, or that the location and dimensions of the sites visited corresponded with the extent of the BVI Standing Timber Assets reported by Sino-Forest. Consequently, this audit procedure was poorly designed to detect a material misstatement.

(b) Reliance on Pöyry Valuations

73. GAAS sets out explicit requirements to be met when an auditor places reliance on work performed by a specialist in the course of an audit. Ernst & Young did not meet these requirements in placing reliance on Pöyry's valuation work when obtaining assurance relating to the existence of the BVI Standing Timber Assets. It did not explicitly communicate to Pöyry its intention to rely upon Pöyry's valuation work as audit evidence of the existence of the BVI Standing Timber Assets.

Insufficient Skepticism

74. Ernst & Young failed to conduct its audit work relating to the existence and ownership of the BVI Standing Timber Assets recognized in the Material Financial Statements with a sufficient level of professional skepticism.

75. As outlined above, Ernst & Young failed to adequately respond to a number of facts and findings that came to its attention in the course of conducting the audits of the Material Financial Statements. These facts and findings should have caused Ernst & Young to treat the representations of Sino-Forest management with greater caution and to perform additional audit procedures and to obtain additional evidence from independent sources in relation to the BVI Standing Timber Assets.

Consequences of Ernst & Young's Actions

76. Ernst & Young's failures to comply with GAAS, as outlined above, led them to overlook or discount flaws in Sino-Forest's assertions relating to the ownership and existence of the BVI Standing Timber Assets. The BVI Standing Timber Assets constituted the vast majority of Sino-Forest's assets and produced nearly all of its reported revenue.

Breaches of Ontario Securities Law

77. Each of Ernst & Young's failures to comply with GAAS in the course of its audits of each of the Material Financial Statements constituted a breach of sections 78(2) and 78(3) of the *Securities Act*.

78. In addition, the audit failures of Ernst & Young outlined above were contrary to the public interest.

D. Audits of Zungui Haixi Corporation

Background

79. In August 2008, Mengshida Shoes Co. Ltd. Shishi City (“Mengshida”) was a privately-owned entity that was managed and controlled by three brothers. It was engaged in the manufacture of athletic footwear, apparel, accessories and casual footwear, and it represented that it sold these products to 47 independently-owned distributors located throughout the PRC.

80. During 2008, Mengshida explored the possibility of listing its shares on a public exchange, and on August 22, 2008, it engaged Ernst & Young to audit the financial statements of the company and related entities in preparation for a public offering in Canada. This engagement became the IPO Audit, encompassing the consolidated financial statements of Southern Trends International Holding Company Limited, the holding company for Mengshida (“Southern Trends”) as at and for the years ended December 31, 2006, December 31, 2007, December 31, 2008 and as at and for the six-month period ended June 30, 2009.

81. Zungui was formed to carry out the IPO, and to acquire the shares of Southern Trends in transactions described in the IPO prospectus. Ernst & Young’s audit reports on the consolidated financial statements of Southern Trends were included in Zungui’s IPO prospectus.¹

82. Following the IPO, Zungui engaged Ernst & Young as auditor and Ernst & Young performed the 2010 Audit, encompassing Zungui’s financial statements as at and for the year ended June 30, 2010.

83. In June 2011, Zungui engaged Ernst & Young for an audit of its financial statements as at and for the year ended June 30, 2011 (the “2011 Audit”).

84. In conducting the 2011 Audit, Ernst & Young modified its bank confirmation procedures in light of widely publicized reports of bank fraud involving a PRC-based

¹ Hereinafter, “Zungui” refers to Zungui and the companies that became its subsidiaries.

U.S. issuer. During the 2011 Audit, Ernst & Young experienced irregularities when conducting bank confirmation procedures for Zungui's principal operating bank account held with the Agricultural Bank of China. Ernst & Young extended its procedures and identified anomalies in original bank transfer advice documents provided by Zungui to Ernst & Young, purporting to evidence payments to Zungui by certain of its distributors. Ernst & Young also discovered irregularities relating to certain of Zungui's value-added tax invoices.

85. Ernst & Young elevated its concerns to Zungui's audit committee, and shortly thereafter Ernst & Young suspended the 2011 Audit and recommended that the audit committee investigate these issues, noting that further audit work would not be useful until its concerns were addressed by Zungui.

86. On August 22, 2011, Zungui's Board of Directors issued a press release announcing that Ernst & Young had suspended the 2011 Audit. After the press release was issued, the market price of Zungui shares dropped by over 75% in a single day of trading.

87. On August 28, 2011, Zungui's Board of Directors appointed a committee of independent directors to investigate the issues raised by Ernst & Young, but could not obtain sufficient funds from the company's PRC operating subsidiary to conduct its investigation. As a result, all four of Zungui's independent directors and its Chief Financial Officer resigned, leaving the company with no directors or officers residing in Canada.

88. On September 23, 2011, Ernst & Young resigned as the auditor of Zungui. In its resignation letter, Ernst & Young requested that Zungui take all necessary steps to prevent future reliance on the IPO auditor's report or the 2010 auditor's report.

89. Zungui was required to file its audited financial statements for its 2011 fiscal year with the Commission by October 28, 2011, but failed to do so, and has failed to make any filings with the Commission since that date.

90. On November 7, 2011, Staff issued a Statement of Allegations naming Zungui and its remaining directors in relation to the company's failure to file audited annual financial statements, among other things.

91. The Commission held a hearing on February 2, 2012 in which it found that Zungui committed multiple violations of Ontario securities law, including a failure to file audited annual financial statements. It also found that the remaining directors of Zungui committed multiple violations of Ontario securities law, including authorizing, permitting or acquiescing in Zungui's violations.

92. Following a sanctions hearing, the Commission issued a decision on August 28, 2012 ordering, among other things, that all Zungui securities be permanently cease traded.

Ernst & Young's Failures to Meet Generally Accepted Auditing Standards

93. Ernst & Young failed to comply with GAAS by failing to obtain reasonable assurance that the financial statements audited during the IPO Audit and 2010 Audit were not materially misstated. In particular, Ernst & Young:

- a. failed to obtain sufficient appropriate audit evidence,
- b. failed to exercise a sufficient level of professional skepticism, and
- c. failed to conduct a sufficient review of the audit evidence.

Failure to Obtain Sufficient Appropriate Audit Evidence

94. In the IPO Audit and the 2010 Audit, Ernst & Young planned and performed various audit procedures and obtained audit evidence with respect to Zungui's purchases, sales and revenue.

95. In addition, at the initial stages of the IPO Audit, Ernst & Young identified fraud risks, including a risk that Zungui could use fictitious distributors and suppliers to inflate

its revenue. To address the risk of fictitious distributors and suppliers, Ernst & Young designed and performed two specific audit procedures for the IPO Audit:

- a. it engaged Central Business Information Limited (“CBI”), a Hong Kong business intelligence company, to conduct research on Zungui’s key distributors and suppliers, and
- b. it independently confirmed Zungui’s accounts receivable and accounts payable transaction balances with selected distributors and suppliers.

(a) CBI Reports for Distributors and Suppliers

96. During the IPO Audit, CBI conducted research on Zungui’s ten largest distributors and three largest original equipment manufacturer (“OEM”) suppliers. CBI provided reports that confirmed that the distributors and suppliers were registered with the relevant Chinese authorities, and provided information as to their legal representatives and shareholders, none of whom appeared to be related parties. However, CBI’s reports regarding the distributors and suppliers also raised the following issues:

- a. CBI obtained information indicating that two of Zungui’s distributors had been established in 2007, but Zungui had reported significant sales to these distributors prior to 2007.
- b. CBI was unable to contact Zungui’s fourth largest distributor through contact information provided by Zungui, or through directory inquiries, internet searches or telephone calls to entities supposedly associated with the distributor.
- c. CBI obtained financial information about five of Zungui’s distributors, but in each instance the entire amount of inventory purchased by the distributor was lower than the amount of inventory Zungui purported to have sold to them.
- d. CBI obtained information about the production capacity of two OEM suppliers, and in both cases the entire annualized production capacity of the

OEM supplier appeared lower than the annualized production quantity that Zungui purportedly outsourced to them.

- e. CBI obtained information about the brand names of products distributed by nine of Zungui's distributors; eight of them did not make any reference to the distribution of Zungui's brand.

97. Ernst & Young concluded that the CBI reports had established the existence of the distributors and suppliers, and did not indicate the presence of related parties.

98. However, the issues raised by the CBI reports should have prompted Ernst & Young to perform additional procedures in response. The number and pervasiveness of the issues raised by the CBI reports also should have prompted Ernst & Young to re-evaluate all of the audit evidence relating to distributors and suppliers and to design new procedures to assess the legitimacy of these entities.

99. In the 2010 Audit, Ernst & Young relied on the CBI reports prepared for the IPO Audit, noting that "nothing unusual" had been uncovered by the CBI reports and that the reports had established the existence of all of the ten largest distributors.

(b) Accounts Receivable and Accounts Payable Confirmations

100. In addition to the CBI reports, Ernst & Young also used a confirmation procedure to address the risk of fictitious distributors and suppliers in the IPO Audit. To carry out this procedure, Ernst & Young obtained addresses for selected distributors and suppliers from Zungui.

101. During the IPO Audit, Ernst & Young sent a total of 159 letters (referred to as "confirmations") from Zungui's premises to the addresses provided in order to confirm the distributors' account receivable balances and the suppliers' account payable balances as at current and prior period-end dates.

102. Despite the fact that multiple confirmations were sent to addresses that were incomplete and that CBI had not been able to verify, 158 confirmations were returned. These confirmations confirmed the exact transaction balances, with no reconciling items

noted. Moreover, nearly all of the confirmations were signed within seven days of their mailing.

103. For the 2010 Audit, Ernst & Young sent 42 confirmations. All of the confirmations were returned and they confirmed the exact transaction balances, with no reconciling items noted. Moreover, nearly all of the confirmations were signed within seven days of their mailing.

104. As a result of substantially all confirmations being returned in an unusually short timeframe without reconciling items, Ernst & Young ought to have considered the quality of the audit evidence obtained from the accounts receivable and accounts payable confirmations and to reconsider whether this procedure could be relied upon to address the risk of fictitious distributors and suppliers.

Failure to Exercise Sufficient Professional Skepticism

105. The issues raised by the CBI reports regarding certain of Zungui's distributors and suppliers, and the unusually positive response to its confirmations, should have raised Ernst & Young's general concern about the possibility of fraud.

106. In addition, during the IPO Audit Ernst & Young also received a report from CBI regarding Zungui, which included revenue and earnings information purportedly filed by Zungui with Chinese authorities that was significantly lower than the information that Zungui had provided to Ernst & Young about its revenue and earnings. Ernst & Young noted the discrepancy, but did not perform any procedures to obtain an understanding of the reasons for the discrepancies.

107. These circumstances should have caused Ernst & Young to treat the representations from Zungui management with greater caution and to obtain additional audit evidence from independent sources.

Failure to Conduct Sufficient Review

108. Ernst & Young performed an insufficient level of review for the IPO Audit and the 2010 Audit in light of Zungui being a foreign-based issuer with an identified risk of fictitious distributors and suppliers, as well as other engagement specific factors.

Breaches of Ontario Securities Law

109. Ernst & Young's failures to comply with GAAS in the IPO Audit and 2010 Audit, as outlined above, led it to overlook or discount issues relating to the fair presentation of Zungui's financial statements.

110. Each of Ernst & Young's failures to comply with GAAS requirements during the IPO Audit constituted a breach of National Instrument 41-101–*General Prospectus Requirements* and National Instrument 52-107 and each failure to comply with GAAS in the 2010 Audit constituted a breach of section 78(2) and 78(3) of the *Securities Act* and National Instrument 52-107.

111. The audit failures of Ernst & Young outlined above were contrary to the public interest.

E. Mitigating Factors

112. Staff's core allegation in each of the Proceedings is that Ernst & Young failed to conduct audits of year-end financial statements of a reporting issuer operating in the PRC in accordance with GAAS, resulting in breaches of the *Securities Act*.

113. Staff do not allege, and have found no evidence of, dishonest conduct by Ernst & Young.

114. During Staff's investigation of Sino-Forest, Ernst & Young produced preliminary documents without a summons and witnesses for examination from outside the jurisdiction. In Zungui, Ernst & Young co-operated by providing Staff with an affidavit sworn by one of its partners. Further, it was through Ernst & Young's escalation of its

concerns to Zungui's Audit Committee in August 2011 during the audit of Zungui's 2011 financial statements that its financial reporting irregularities came to light.

115. Subsequent to the events at issue, the Commission published the EMIR Report and the Guide, providing guidance and recommendations concerning governance and disclosure practices for issuers with significant operations in emerging markets and their advisors.

116. Ernst & Young settled class action lawsuits relating to its audits of the financial statements of Sino-Forest before the Ontario Court, the Quebec Court and the U.S. Court and relating to its audits of the financial statements of Zungui before the Ontario Court by paying a total of \$119 million to shareholders and noteholders of Sino-Forest and shareholders of Zungui. The settlements were found by the respective Courts adjudicating upon them to be fair and reasonable.

117. The hearing in the Sino-Forest Proceeding is scheduled to commence on November 11, 2014 and the hearing in the Zungui Proceeding is scheduled to commence on May 1, 2015.

118. Settlement of the Proceedings will avoid two complex and lengthy hearings dealing with the interpretation and application of auditing standards in connection with audits of financial statements of reporting issuers, the exercise of professional judgment and the conflicting reports of multiple expert witnesses.

119. Ernst & Young has advised Staff that since 2011, as part of its ongoing process to improve audit policies and procedures in response to the changing business environment, new standards, and current practice developments, Ernst & Young has implemented enhancements in its policies and procedures for auditing companies with significant operations in emerging markets and its client continuance and acceptance processes, and has made significant ongoing investments in its audit quality support structures.

120. Ernst & Young has also advised Staff that after the events at issue, it conducted a focussed assessment of its audits of entities with principal operations in the PRC. For in-progress or continuing audits, Ernst & Young dedicated additional resources as

appropriate to address the heightened risks, and in other instances discontinued as auditor.

121. Ernst & Young has agreed to cooperate with Staff regarding its ongoing investigation into the affairs of Sino-Forest and any resulting hearing before the Commission. Ernst & Young will make its current partners and employees available to testify at any resulting hearing if requested by Staff and will make best efforts to cause its former partners and employees to do so.

122. Ernst & Young has agreed to make a voluntary payment of \$8 million to the Commission which includes \$2.1 million to be allocated to costs, to advance the Commission's mandate of protecting investors and fostering fair and efficient capital markets. Staff are of the view that the voluntary payment in addition to amounts already paid in the class action settlements will send a message to the marketplace that Staff expect that auditors of reporting issuers will exercise the appropriate level of scrutiny, professional skepticism and diligence in the performance of financial statement audits, and that Staff will not hesitate to initiate proceedings where it considers that this has not occurred.

123. Ernst & Young will pay the agreed settlement amount of \$8 million by wire transfer before the commencement of the hearing before the Commission to approve this Settlement Agreement, conditional upon the approval of the Settlement Agreement by the Commission.

124. The terms of settlement are appropriate, having regard to the nature of Staff's allegations, mitigating factors and the principles of general and specific deterrence.

PART IV — TERMS OF SETTLEMENT

125. Ernst & Young agrees to the terms of settlement listed below and consents to the Order attached hereto, pursuant to subsection 127(1) and section 127.1 of the *Securities Act* that:

- a. the Settlement Agreement is approved;

b. Ernst & Young agrees to make a voluntary payment of \$8 million. The voluntary payment will be allocated as follows:

(i) a voluntary payment of \$6.5 million with respect to the Sino-Forest Proceeding, of which \$1.5 million shall be allocated to the costs of the investigation, and the balance shall be designated for allocation or for use by the Commission in accordance with subsections 3.4(2)(b)(i) or (ii) of the *Securities Act*; and

(ii) a voluntary payment of \$1.5 million with respect to the Zungui Proceeding, of which \$600,000 shall be allocated to the costs of the investigation, and the balance shall be designated for allocation or for use by the Commission in accordance with subsections 3.4(2)(b)(i) or (ii) of the *Securities Act*.

126. Ernst & Young agrees to make the payments described above by wire transfer before the commencement of the hearing before the Commission to approve this Settlement Agreement, which shall be returned to Ernst & Young if the Settlement Agreement is not approved by the Commission.

PART V - STAFF COMMITMENT

127. If the Commission approves this Settlement Agreement, Staff will not commence any proceeding under Ontario securities law in relation to the audits described in the Staff's Statement of Facts and Conclusions set out in Part III of this Settlement Agreement, subject to the provisions of paragraph 128 below.

128. If the Commission approves this Settlement Agreement and Ernst & Young fails to comply with any of the terms of the Settlement Agreement, Staff may bring proceedings under Ontario securities law against Ernst & Young. These proceedings may be based on, but are not limited to, the Staff's Statement of Facts and Conclusions set out in Part III of this Settlement Agreement as well as the breach of this Settlement Agreement.

PART VI - PROCEDURE FOR APPROVAL OF SETTLEMENT

129. The parties will seek approval of this Settlement Agreement at a public hearing before the Commission scheduled for September 30, 2014, or on another date agreed to by Staff and Ernst & Young, according to the procedures set out in this Settlement Agreement and the Commission's Rules of Procedure.

130. Staff and Ernst & Young agree that this Settlement Agreement will form all of the evidence that will be submitted at the settlement hearing on Ernst & Young's conduct, unless the parties agree that additional evidence should be submitted at the settlement hearing.

131. If the Commission approves this Settlement Agreement, Ernst & Young agrees to waive all rights to a full hearing, judicial review or appeal of this matter under the *Securities Act*.

132. If the Commission approves this Settlement Agreement, Ernst & Young will not make any public statement that is inconsistent with this Settlement Agreement or with any additional evidence submitted at the settlement hearing. In addition, Ernst & Young agrees that it will not make any public statement that there is no factual basis for the Settlement Agreement. Nothing in this paragraph affects Ernst & Young's testimonial obligations or the right to take legal or factual positions in other investigations or legal proceedings in which the Commission and/or Staff is not a party or in which any provincial or territorial securities regulatory authority in Canada and/or its staff is not a party ("Other Proceedings") or to make public statements in connection with Other Proceedings.

133. Whether or not the Commission approves this Settlement Agreement, Ernst & Young will not use, in any proceeding, this Settlement Agreement or the negotiation or process of approval of this agreement as the basis for any attack on the Commission's jurisdiction, alleged bias, alleged unfairness, or any other remedies or challenges that may otherwise be available.

PART VII - DISCLOSURE OF SETTLEMENT AGREEMENT

134. If the Commission does not approve this Settlement Agreement or does not make the order attached as Schedule “A” to this Settlement Agreement:

- a. this Settlement Agreement and all discussions and negotiations between Staff and Ernst & Young before the settlement hearing takes place will be without prejudice to Staff and Ernst & Young; and
- b. Staff and Ernst & Young will each be entitled to all available proceedings, remedies and challenges, including proceeding to a hearing of the allegations contained in the Statement of Allegations. Any proceedings, remedies and challenges will not be affected by this Settlement Agreement, or by any discussions or negotiations relating to this agreement.

135. Both Parties will keep the terms of the Settlement Agreement confidential until the commencement of the public hearing to obtain approval of this Settlement Agreement by the Commission. Any obligations of confidentiality shall terminate upon the commencement of the public settlement hearing. If, for whatever reason, the Commission does not approve the Settlement Agreement, the terms of the Settlement Agreement remain confidential indefinitely, unless Staff and Ernst & Young otherwise agree or if required by law.

PART VIII - EXECUTION OF SETTLEMENT AGREEMENT

136. This agreement may be signed in one or more counterparts which, together, constitute a binding agreement.

137. A facsimile copy or other electronic copy of any signature will be as effective as an original signature.

Dated this 22nd day of September, 2014.

“Doris Stamm”
Ernst & Young LLP
I have the authority to bind the partnership

“Anita Thakkar”
Witness

Dated this 23rd day of September, 2014.

“Tom Atkinson”
Tom Atkinson
Director, Enforcement Branch

Schedule “A”



Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

22nd Floor
20 Queen Street West
Toronto ON M5H 3S8

22e étage
20, rue queen ouest
Toronto ON M5H 3S8

**IN THE MATTER OF THE *SECURITIES ACT*,
R.S.O. 1990, c. S.5, AS AMENDED**

- and -

IN THE MATTER OF ERNST & YOUNG LLP

- and -

**IN THE MATTER OF ERNST & YOUNG LLP
(AUDITS OF ZUNGUI HAIXI CORPORATION)**

- and -

**IN THE MATTER OF A
SETTLEMENT AGREEMENT
BETWEEN STAFF OF THE ONTARIO SECURITIES COMMISSION
AND ERNST & YOUNG LLP**

**ORDER
(Sections 127 and 127.1)**

WHEREAS on December 3, 2012, the Ontario Securities Commission (the “Commission”) issued a Notice of Hearing pursuant to sections 127 and 127.1 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the “*Securities Act*”) in respect of Ernst & Young LLP (“Ernst & Young”). That Notice of Hearing was issued in connection with the allegations set out in the Statement of Allegations of Staff of the Commission (“Staff”) dated December 3, 2012 relating to Ernst & Young’s audits of the financial statements of Sino-Forest Corporation (the “Sino-Forest Proceeding”);

AND WHEREAS on June 24, 2013, the Commission issued a second Notice of Hearing pursuant to sections 127 and 127.1 of the *Securities Act* in respect of Ernst & Young. That Notice of Hearing was issued in connection with the allegations set out in the Statement of Allegations of Staff dated June 24, 2013 relating to Ernst & Young's audits of the financial statements of Zungui Haixi Corporation (the "Zungui Proceeding");

AND WHEREAS Ernst & Young entered into a Settlement Agreement with Staff dated September 5, 2014 (the "Settlement Agreement") in which Ernst & Young agreed to a proposed settlement of the Sino-Forest Proceeding and the Zungui Proceeding, subject to the approval of the Commission;

AND WHEREAS on September 19, 2014, the Commission issued a Notice of Hearing pursuant to section 127 of the *Securities Act* to announce that it proposed to hold a hearing to consider whether it is in the public interest to approve the Settlement Agreement;

AND UPON reviewing the Settlement Agreement, the Notices of Hearing, and the Statements of Allegations of Staff in the Sino-Forest Proceeding and the Zungui Proceeding, and upon hearing submissions from counsel for Ernst & Young and from Staff;

AND WHEREAS Ernst & Young has undertaken in the Settlement Agreement to cooperate with Staff regarding its ongoing investigation into the affairs of Sino-Forest Corporation and any resulting hearing before the Commission. Ernst & Young has further undertaken to make its current partners and employees available to testify at any resulting hearing if requested by Staff and make best efforts to cause its former partners and employees to do so;

AND WHEREAS the Commission is of the opinion that it is in the public interest to make this Order;

IT IS HEREBY ORDERED THAT:

- (a) the Settlement Agreement is approved;
- (b) Ernst & Young shall make a voluntary payment to the Commission in the amount of \$8 million in total, to be allocated as follows:
 - (i) \$6.5 million for the Sino-Forest Proceeding, of which \$1.5 million shall be allocated to the Commission's costs of the investigation, and the balance shall be designated for allocation or for use by the Commission in accordance with subsections 3.4(2)(b)(i) or (ii) of the *Securities Act*; and
 - (ii) \$1.5 million for the Zungui Proceeding, of which \$600,000 shall be allocated to the Commission's costs of the investigation, and the balance shall be designated for allocation or for use by the Commission in accordance with subsections 3.4(2)(b)(i) or (ii) of the *Securities Act*.

DATED at Toronto, this • day of September, 2014.
