

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

**- AND -**

**IN THE MATTER OF  
ERNST & YOUNG LLP**

**STATEMENT OF ALLEGATIONS**

Further to a Notice of Hearing dated December 3, 2012, Staff of the Ontario Securities Commission (“Staff”) make the following allegations:

**Overview**

1. Ernst & Young LLP (“Ernst & Young”) were the auditors of Sino-Forest Corporation (“Sino-Forest”) between August 2007 and April 2012. During that time, they audited the annual consolidated financial statements of Sino-Forest and represented to its shareholders that they had performed their audits in accordance with relevant industry standards. Shareholders invested significant sums in Sino-Forest in reliance on these financial statements.
  
2. Ernst & Young, however, failed to conduct their audits in accordance with relevant industry standards. In particular, as outlined further below, Ernst & Young:
  - (a) failed to perform sufficient audit work to verify Sino-Forest’s ownership of its most significant assets;
  
  - (b) failed to perform sufficient audit work to verify the existence of Sino-Forest’s most significant assets; and
  
  - (c) failed to undertake their audit work on the Sino-Forest engagement with a sufficient level of professional skepticism.

3. As the auditors of a publicly traded company, Ernst & Young were required to conduct their audits of Sino-Forest's financial statements in accordance with Canadian generally accepted auditing standards ("GAAS"). Each of Ernst & Young's failures to comply with GAAS in the course of its audits of these financial statements constitutes a breach of section 78 of the *Securities Act*, R.S.O. 1990, c. S-5, as amended (the "Securities Act").

4. In addition, Sino-Forest filed a number of documents with the Ontario Securities Commission (the "Commission") which contained Ernst & Young's representation that they had conducted their audits in accordance with GAAS. Each of these filings constitutes a breach of section 122 of the *Securities Act* by Ernst & Young.

### **Background**

5. Sino-Forest is a reporting issuer in the province of Ontario as that term is defined in subsection 1(1) of the *Securities Act*. Sino-Forest represented that it engaged primarily in the purchase and sale of timber located in the People's Republic of China (the "PRC"). Until May 9, 2012, the common shares of Sino-Forest were listed and posted for trading on the Toronto Stock Exchange.

6. Ernst & Young is a firm of chartered accountants with a head office located in Toronto, Ontario. It has offices located across Canada, and it is a member firm of Ernst & Young Global Limited, a global accounting organization.

7. Ernst & Young was appointed as the auditor of Sino-Forest on August 16, 2007. Ernst & Young 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").

8. Between February 2003 and October 2010, Sino-Forest raised approximately US \$3.0 billion through the issuance of equity and debt securities to investors. From 2008 onwards, investors relied on the Material Financial Statements in making the decision to purchase Sino-Forest's shares and debt securities in both the primary and secondary markets.

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

10. On June 2, 2011, the share price of Sino-Forest plummeted after a private analyst made public allegations of fraud against Sino-Forest. On the same day, the Board of Directors of Sino-Forest established an Independent Committee (the "IC") "to independently examine and review the serious and wide-ranging allegations" made in the analyst's report.

11. 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").

12. In the IC Reports, the IC presented its findings regarding the issues of tree ownership and tree existence. The IC Reports concluded that there was uncertainty surrounding the legal certainty of Sino-Forest's claims to a significant proportion of its reported timber assets. In addition, the IC Reports noted significant obstacles to verifying the actual existence of the reported timber assets, including an inability to identify the precise location of the trees which had purportedly been purchased by Sino-Forest.

13. On November 15, 2011, Sino-Forest announced that it would defer the release of its interim filings for the third quarter of 2011. Sino-Forest has not filed these interim filings with the Commission.

14. On January 10, 2012, Sino-Forest took the unusual step of issuing a press release cautioning that its historic financial statements and related audit reports should not be relied upon.

15. 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 Superior Court of Justice requesting protection from its creditors. Sino-Forest has not filed the 2011 Financial Statements with the Commission.

16. 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 the caution that its historic financial statements and related audit reports should not be relied upon. The Change of Auditor Notice did not name a successor auditor.

17. On May 22, 2012, Staff issued a Statement of Allegations naming Sino-Forest and six members of its executive management team (the “Sino-Forest SOA”). The Sino-Forest SOA alleged that five of the named members of Sino-Forest’s executive management team, including the Chairman and Chief Executive Officer “engaged in a complex fraudulent scheme to inflate the assets and revenue of Sino-Forest and made materially misleading statements in Sino-Forest’s public disclosure record related to its primary business”.

### **The Purported Business of Sino-Forest**

18. The majority of Sino-Forest’s reported business involved the purchase and sale of trees which were categorized on its balance sheet as “Timber Holdings” and commonly referred to as “Standing Timber”.

19. Standing Timber was purportedly 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”).

20. In the BVI Model, Sino-Forest’s purported purchases and sales of Standing Timber were conducted using wholly owned subsidiaries of Sino-Forest incorporated in the British Virgin Islands (the “BVI Subsidiaries”). The BVI Subsidiaries purported to enter into written purchase contracts with suppliers located in the PRC (the “Purchase Contracts”) and then purported to enter into written sales contracts with customers called “authorized intermediaries” also located in the PRC (the “Sales Contracts”).

21. In the WFOE Model, Sino-Forest used subsidiaries incorporated in the PRC called Wholly Foreign-Owned Enterprises (“WFOEs”) to acquire, cultivate and sell the Standing Timber. The Sino-Forest WFOEs also entered into purchase contracts and sales contracts with other parties in the PRC.

22. Sino-Forest purported to conduct the majority of its business through the BVI Model. 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 purportedly held in the BVI Model, comprising approximately 467,000 hectares of Standing Timber.

23. 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
<b>Standing Timber Revenue</b>	<b>521.5</b>	<b>685.4</b>	<b>954.2</b>	<b>1,401.2</b>	<b>3,562.3</b>
<b>Total Revenue</b>	<b>713.9</b>	<b>896.0</b>	<b>1,238.2</b>	<b>1,923.5</b>	<b>4,771.6</b>
 BVI Model as % of Total Revenue	 70%	 72%	 71%	 69%	 70%

#### **Ernst & Young's Obligations as Auditor**

24. As a reporting issuer, Sino-Forest was required by section 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.

25. As the auditor of a reporting issuer, Ernst & Young was required by section 3 of National Instrument 52-107 – *Acceptable Accounting Principles and Auditing Standards*, and by sections 78(2) and 78(3) of the Securities Act to audit the Material Financial Statements in accordance with GAAS and to prepare an auditors' report to accompany the financial statements.

26. Each of the Material Financial Statements was accompanied by an auditors' report, prepared by Ernst & Young, addressed to the shareholders of Sino-Forest (the "Auditors' Report"). In each Auditors' Report, Ernst & Young represented that it had conducted its audits in accordance with GAAS. The Auditors' 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 with the Commission along with the Material Financial Statements.

27. In addition, 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 Auditors’ Report. In addition, in letters addressed to and filed with the Commission along with the Short Form Prospectuses (the “Prospectus Consent Letters”), Ernst & Young consented to use of their Auditors’ Report by Sino-Forest and further stated that they had “no reason to believe that there are any misrepresentations” contained in the relevant Auditors’ Report.

### **Generally Accepted Auditing Standards**

28. As set out in GAAS, an auditor’s objective is to identify and assess the risks of material misstatement, whether due to fraud or error, in an entity’s financial statements. An auditor can achieve this objective by understanding the entity and its environment, including the entity’s internal controls. This understanding provides the auditor with a basis for designing and implementing responses to the assessed risks.

#### **(a) Sufficient Audit Evidence Required**

29. GAAS requires auditors to obtain reasonable assurance that the entity’s financial statements are free from material misstatements. Reasonable assurance is a high level of assurance. It is achieved when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to a low level and to provide a reasonable basis to support the content of the audit report. The sufficiency of the audit evidence gathered by the auditor is influenced by the level of materiality set for the audit and the level of risk associated with the audit.

30. The sufficiency and the appropriateness of the audit evidence gathered by the auditor are interrelated. Sufficiency is the measure of the quantity of the audit evidence.

The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of misstatement. That is, the higher the assessed risks, the more audit evidence is likely to be required. The quantity of audit evidence needed is also affected by the quality of the audit evidence. That is, the higher the quality of the audit evidence, the less audit evidence may be required.

31. Obtaining more audit evidence, however, may not compensate for its poor quality. Appropriateness is the measure of the quality of the audit evidence; that is its relevance and its reliability in providing support for the conclusions on which the auditor's opinion is based. The reliability of the audit evidence is influenced by its source and by its nature, and is dependent on the circumstances in which it is obtained.

**(b) Professional Skepticism Required**

32. GAAS requires auditors to plan and perform their audits using professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism requires a questioning attitude which is alert to conditions which may indicate possible misstatement due to error or fraud. Professional skepticism requires an auditor to conduct a critical assessment of the audit evidence.

33. Professional skepticism requires the auditor to be alert to, amongst other things:

- (a) audit evidence that contradicts other audit evidence obtained;
- (b) information that brings into question the reliability of documents and responses to inquiries;
- (c) conditions that may indicate possible fraud; and
- (d) circumstances that suggest the need for additional audit procedures in addition to those required by minimum written professional standards.

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

34. Ernst & Young failed to comply with GAAS by failing to obtain reasonable assurance that the Material Financial Statements were not materially misstated.

35. In particular, Ernst & Young failed to obtain sufficient appropriate audit evidence with respect to the ownership and existence of the Standing Timber that Sino-Forest purported to hold through the BVI Model (the "Purported Assets").

36. In addition, Ernst & Young failed to exercise sufficient professional skepticism when conducting the audits of the Material Financial Statements. This contributed to the failure to obtain sufficient appropriate audit evidence with respect to the ownership and existence of the Purported Assets.

### **A. Failure to Adequately Address Ownership of Timber**

37. The audit procedures performed by, and the audit evidence obtained by Ernst & Young with respect to Sino-Forest's ownership of the Purported Assets, were deficient in a number of respects.

#### **(i) Flawed Purchase Contracts**

38. One of the audit procedures that Ernst & Young performed relating to the ownership of the Purported Assets was a review of all of the Purchase Contracts entered into by Sino-Forest 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. The Purchase Contracts, however, had two significant deficiencies.

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

40. The Villagers' Letters authorized the seller to sell the timber rights set out in the Purchase Contract. The Certificates reflected the contents of the official PRC government registers concerning ownership of the rights to the relevant timber. Ernst & Young never obtained either the Villagers' Letters or the Certificates.

41. The second deficiency was that the specific location of the Purported Assets was not clearly delineated in either the Purchase Contract or any of its available appendices.

42. Both of these deficiencies 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 Purported Assets. In particular, Ernst & Young failed to make further inquiries concerning the two missing appendices, and failed to take steps to understand the process used by Sino-Forest management to precisely identify the location of the Purported Assets.

43. In addition, Ernst & Young failed to consider that all of the Survey Reports had been prepared by the same survey firm, even though the areas purportedly surveyed were widely scattered throughout the PRC. This unusual circumstance should have prompted Ernst & Young to perform further procedures regarding the source and reliability of the surveys.

**(ii) Flawed Legal Opinion**

44. Ernst & Young failed to obtain a sufficient understanding of the legal basis of Sino-Forest's claim to the Purported Assets. During the audit of the 2007 Financial Statements, Ernst & Young asked Sino-Forest to obtain a legal opinion prepared by Jingtian & Gongchen Attorneys at Law ("Jingtian"). Jingtian were Sino-Forest's corporate counsel located in the PRC. Jingtian prepared an opinion dated March 10, 2008 addressed to Sino-Forest (the "Jingtian Opinion") which was provided to Ernst & Young for its review.

45. 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 Purported Assets. Ernst & Young had selected the representative Purchase Contract that was sent to Jingtian for its review in preparing the Jingtian Opinion.

46. Ernst & Young failed to appreciate and respond to the limitations of the Jingtian Opinion. In particular:

- (a) Ernst & Young failed to consider the fact that it had never obtained copies of the Villagers' Letters or the Certificates for any Purchase Contract; and
- (b) Ernst & Young failed to consider the implications of, or make further inquiries concerning, the disclaimer contained in the Jingtian Opinion that the Villagers' Letters and the Certificates had not been reviewed by Jingtian.

47. The Jingtian Opinion did discuss the status of the Certificates in the PRC legal regime. It noted that the PRC forestry authorities were reporting significant delays and backlogs in the production of the new form of these Certificates. The Jingtian Opinion went on to report, however, that back in 2002 the PRC authorities had predicted that such Certificates would become available beginning in approximately 2004. Ernst & Young failed to follow up on this statement and failed to inquire why the new Certificates were not available by the time the Jingtian Opinion was produced in 2008.

48. Ernst & Young failed to make further inquiries of Sino-Forest management concerning the absence of both the Villagers' Letters and the Certificates from the Purchase Contracts and failed to perform appropriate additional audit procedures relating to Sino-Forest's ownership of the Purported Assets. In particular, and given that Ernst & Young had reviewed copies of Certificates that had been issued for timber acquisitions made through the WFOE Model, Ernst & Young failed to question the absence of

Certificates relating to the Purported Assets and failed to obtain independent audit evidence to support the absence of the Certificates.

49. Further, given that the Jingtian Opinion had described anticipated changes in the PRC's legal regime relating to timber assets, Ernst & Young failed to obtain an updated independent legal opinion for the audits of the 2008, 2009 and 2010 Financial Statements specifically addressing Sino-Forest's ownership of the Purported Assets and the current status of the Certificates in the PRC legal system.

**B. Failure to Adequately Address Existence of Timber**

50. Ernst & Young failed to perform sufficient appropriate audit procedures to verify the existence of the Purported Assets. Ernst & Young recognized that several aspects of Sino-Forest's business resulted in higher inherent risks relating to the existence of the Purported Assets, but they failed to adequately respond to these risks.

51. In particular, Sino-Forest did not make direct cash payments for the acquisition of the Purported 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.

**(i) Limited Site Visits**

52. Ernst & Young performed only very limited site visits to inspect the Purported Assets, which were represented to be widely scattered throughout the PRC. The audit procedures that Ernst & Young performed in connection with these site visits were both insufficient and inappropriate to respond to the identified risks relating to the existence of the Purported Assets.

**(ii) Inappropriate Reliance on Valuations**

53. Sino-Forest engaged Pöyry Forest Industry Ltd. (“Poyry”) to prepare periodic valuations of its Timber Holdings. Ernst & Young inappropriately relied on Poyry’s valuation work in obtaining assurance of the existence of the Purported Assets.

54. GAAS sets out explicit requirements to be met when an auditor places reliance on work performed by another entity in the course of an audit. Ernst & Young failed to meet these requirements in placing reliance on Poyry’s valuation work when assessing the existence of the Purported Assets, as set out below.

55. Ernst & Young was not involved in Poyry’s process of selecting the plantations to sample, the determination of the location of the sampled plantations or in the counting or measuring of the trees. Ernst & Young did attend with Poyry staff during a small number of Poyry’s plantation site visits. During these visits, Ernst & Young staff observed Poyry staff’s activities.

56. Ernst & Young failed, however, to perform any independent audit procedures to ensure that the plantations visited by Poyry were owned by Sino-Forest or that the location and dimensions of the sites visited corresponded with the extent of the Purported Assets reported by Sino-Forest.

57. Further, the valuation reports produced by Poyry contained a clear disclaimer that they should only be relied on by Sino-Forest for its own valuation purposes. Ernst & Young, therefore, placed inappropriate reliance on Poyry’s work in its attempt to verify the existence of the Purported Assets.

58. Some of these limitations were acknowledged by Ernst & Young staff in the course of performing their audits of the Material Financial Statements but were never adequately addressed. For example, in an e-mail exchange between the members of Ernst & Young’s audit team, one auditor posed the question “[h]ow do we know that the

trees that Poyry is inspecting (where we attend) are actually trees owned by the company? E.g. could they show us trees anywhere and we would not know the difference?” Another auditor answered “I believe they could show us trees anywhere and we would not know the difference...”.

### **C. Insufficient Skepticism**

59. Finally, Ernst & Young failed to conduct its audits of the Material Financial Statements with a sufficient level of professional skepticism.

60. As outlined above, Ernst & Young failed to adequately respond to a number of unusual 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.

### **D. Failure to Properly Structure the Audit Team**

61. The failures outlined above were facilitated by Ernst & Young’s failure to properly structure its Sino-Forest engagement team. Many Sino-Forest source documents were produced only in Chinese, including the Purchase Contracts, the Sales Contracts and the Jingtian Opinion. Ernst & Young, however, failed to have these and other key documents translated into English.

62. Ernst & Young’s audit team comprised both Chinese speaking and non-Chinese speaking staff. Several of the senior partners involved in the audits of the Material Financial Statements, however, were unable to read or speak Chinese.

63. Ernst & Young’s non-Chinese speaking staff relied on its Chinese speaking staff to provide informal translations of important source documents. As a result, the non-Chinese speaking staff were often not aware that important information was missing from some of Sino-Forest’s key documents.

**Consequences of Ernst & Young's Failures**

64. Ernst & Young's failures to comply with GAAS, as outlined above, led them to overlook or discount significant flaws in Sino-Forest's assertions relating to the ownership and existence of the Purported Assets. The Purported Assets constituted the vast majority of Sino-Forest's assets and produced nearly all of its reported revenue. Ernst & Young's lack of diligence in these areas therefore resulted in significant negative consequences for Sino-Forest's shareholders.

**Breaches of Ontario Securities Law**

65. Each of Ernst & Young's failures to meet GAAS in the course of its audits of each of the Material Financial Statements constitutes a breach of sections 78(2) and 78(3) of the Securities Act.

66. Each of Ernst & Young's representations contained in each of the Auditors' Reports, which were repeated in each of the Prospectus Consent Letters, that the audits of the Material Financial Statements had been conducted in accordance with GAAS, constitutes a materially misleading a statement contrary to section 122(1)(b) of the Securities Act.

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

68. Staff reserve the right to make such other allegations as Staff may advise and the Commission may permit.

**DATED** at Toronto, Ontario, this 3rd day of December, 2012.