

Ernst & Young reaches \$8-million settlement over Sino-Forest audit



The logo of Ernst & Young is seen at their headquarters in New York.

LUCAS JACKSON/REUTERS

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Accounting firm Ernst & Young admitted no wrongdoing in its audits of Sino-Forest Corp. and another Chinese company, but it has agreed to pay an \$8-million penalty to the Ontario Securities Commission (OSC), co-operate with a fraud investigation, and changed its internal policies on emerging markets.

On Tuesday, the OSC approved a settlement between its staff and Ernst & Young, under which the audit firm will pay the fine to resolve allegations that it performed negligent work.

The OSC says Ernst & Young was negligent in its audits of Sino-Forest, which failed in 2011, and of athletic shoe manufacturer Zungui Haixi Corp. Both companies traded on Canadian stock exchanges until their shares collapsed after being accused of accounting improprieties.

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The settlement is the first high-profile case to use the OSC's no-contest rules, which allow parties to settle without having to make any admissions of wrongdoing. The regulator introduced these kinds of settlements this year as an option for cases that do not involve criminal activity, in order to limit the need for lengthy hearings.

While that means Ernst & Young has neither admitted nor denied it did anything wrong, the OSC maintains the company didn't show enough "professional skepticism" in conducting its audits. OSC lawyer Yvonne Chisholm told the settlement hearing that the accounting firm overlooked flaws in its clients' accounting and didn't conduct proper reviews.

But she also said there is no evidence of "dishonest" conduct by the accounting firm.

Ernst & Young's lawyer Linda Fuerst told the hearing that "the honesty and integrity of Ernst & Young and its people were never in question." She said the settlement avoids the time, expense and uncertainty of what would have been lengthy hearings.

The regulator said the auditor failed to adequately review or question documentation related to Sino-Forest's ownership of standing timber reserves in China. At Zungui, it failed to treat "multiple red flags" in the shoe company's finances with sufficient skepticism, the OSC said.

In addition to the financial payment, Ernst & Young has told the OSC that it put in place new policies for auditing companies that have significant operations in emerging markets, and it has done a "focused assessment" of audits on companies based in China.

It will also make its partners and employees available to testify at the OSC hearing – now ongoing – that is dealing with fraud allegations against Sino-Forest and several of its former executives.

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Ernst & Young long ago reached settlements in class-action suits filed by investors in the two Chinese companies. It agreed to pay \$117-million to Sino-Forest investors and \$2-million to Zungui investors.

Dimitri Lascaris, a class-action lawyer at Siskinds LLP, said the Ernst & Young settlement reinforces his argument that individuals or organizations are not motivated to sign no-contest settlements because of a concern over follow-up civil suits. Since Ernst & Young has already settled its class-actions suits, that cannot be an issue in this case, he said.

The real motivation for no-contest settlements, Mr. Lascaris said, is that firms and individuals want to protect their reputations, and their ability to generate new business.

payment to the OSC will be used to cover its investigative expenses, while the rest will go to "third parties."

Over all, the settlement should send a message to Ernst & Young, and other capital markets participants, that audits need to be conducted with proper levels of diligence, Ms. Chisholm said. OSC vice-chairman James Turner, who approved the settlement, said it underlines the vital "gate keeping" role that auditors play, and that auditors need to show sufficient scrutiny, skepticism and diligence.

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