



Ontario
Securities
Commission

Commission des
valeurs mobilières
de l'Ontario

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

- AND -

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

STATEMENT OF ALLEGATIONS

Further to a Notice of Hearing dated June 24, 2013, Staff of the Ontario Securities Commission (“Staff”) make the following allegations:

Overview

1. On December 21, 2009, the Zungui Haixi Corporation (together with its predecessor entities, “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.
2. In preparation for the IPO, Ernst & Young LLP (“E&Y”) audited Zungui’s consolidated financial statements (the “IPO Audit”) and issued an auditors’ report stating that it had performed the audit in accordance with Canadian generally accepted auditing standards (“GAAS”).
3. E&Y, however, had failed to conduct the IPO Audit in accordance with GAAS, relying on certain audit results that raised more questions than they answered.

4. Specifically, during the course of the audit, E&Y had:
 - (a) identified a risk that Zungui could use fictitious distributors to fraudulently inflate its revenue – but then disregarded evidence suggesting that the company had grossly exaggerated its sales to purported distributors;
 - (b) noted that Zungui’s management had an incentive to manipulate the company’s financial results to attract investors for the IPO – but then failed to treat multiple red flags about the company’s revenue and earnings with appropriate skepticism; and
 - (c) failed to conduct a sufficient review of the audit evidence, leaving the review of key evidence in the hands of a staff member with limited experience.

5. E&Y also conducted an audit of Zungui’s financial statements for its 2010 fiscal year (the “2010 Audit”) and issued an auditors’ report stating that it had performed the audit in accordance with GAAS. E&Y, however, had also failed to conduct the 2010 Audit in accordance with GAAS, as it contained several of the same deficiencies as the IPO Audit.

6. E&Y’s failures to comply with GAAS in conducting the IPO Audit and 2010 Audit constituted breaches of section 78 of the *Securities Act*, R.S.O. 1990, c. S.5, as amended (the “Securities Act”) and National Instruments 41-101 and 52-107. Furthermore, in certain documents that were filed with the Ontario Securities Commission (the “Commission”), E&Y stated that it had conducted the IPO Audit and 2010 Audit in accordance with GAAS. Each of these statements constituted a breach of section 122 of the Securities Act.

Background

Zungui

7. In August 2008, Zungui 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 purported to sell these products to 47 independently-owned distributors located throughout the People's Republic of China ("China").

8. During 2008, Zungui explored the possibility of listing its shares on a public exchange, and on August 22, 2008, it engaged E&Y to audit the company's financial statements in preparation for a public offering in Canada. This engagement became the IPO Audit, encompassing the financial statements of Zungui for the years ended December 31, 2006, December 31, 2007, December 31, 2008 and for the six-month period ended June 30, 2009.

E&Y

9. E&Y 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.

10. To conduct the IPO Audit, E&Y assembled a team overseen by a partner in the firm's China Market Group (the "Partner"). However, as set forth below, the Partner did not review any of the underlying evidence gathered during the audit, instead limiting her review to summary documents. Two independent partners also performed work on the audit, but they also limited their review to summary documents.

11. E&Y's original Senior Manager for the IPO Audit did not understand Chinese and had no experience with audits of China-based companies. After beginning work on the file, she informed the Partner that she was "*clearly not the right person to review the fieldwork in detail as much of the documentation in the working papers is in Chinese*" and

that she “*d[id] not think we’d be meeting our quality standards if you are requiring me to do a detailed review*”.

12. Shortly thereafter, the original Senior Manager was removed from the file and another Senior Manager was appointed. However, the new Senior Manager also did not understand Chinese and also had no auditing experience with China-based companies.

13. E&Y’s Manager for the IPO Audit was a new employee who had recently joined the firm from a South African auditor. He had never conducted an audit of a China-based company, had never conducted an audit governed by GAAS and had never conducted an audit with E&Y. However, despite this limited experience, the Manager was given significant responsibility for overseeing and reviewing key audit work.

IPO Audit

14. At the initial stages of the IPO Audit, E&Y identified fraud risks and designed specific procedures to address them, including a procedure to assess whether Zungui was using fictitious distributors and suppliers to inflate its revenue. This procedure involved the engagement of a Hong Kong business intelligence company to conduct research on certain of Zungui’s distributors and suppliers.

15. As set out in detail below, the Hong Kong company issued reports raising serious issues about Zungui’s dealings with its purported distributors and suppliers, but E&Y failed to address them. In spite of these issues, E&Y completed the IPO Audit and issued an auditors’ report stating that it had conducted the IPO Audit in accordance with GAAS (the “IPO Auditors’ Report”).

2010 Audit

16. In February 2010, Zungui engaged E&Y to perform the 2010 Audit, encompassing Zungui’s financial statements for the year ended June 30, 2010. E&Y identified a fraud risk associated with fictitious distributors and suppliers for this audit as well, but relied on its prior analysis of the Hong Kong reports from the IPO Audit to address the risk. Despite

the issues raised by the Hong Kong reports, E&Y completed the 2010 Audit and issued an auditors' report stating that it had conducted the 2010 Audit in accordance with GAAS (the "2010 Auditors' Report").

2011 Audit

17. In June 2011, Zungui engaged E&Y for an audit of its financial statements for the year ended June 30, 2011 (the "2011 Audit").

18. In conducting the 2011 Audit, E&Y again identified a fraud risk involving fictitious distributors and suppliers. To address the risk, E&Y obtained new reports from the same Hong Kong business intelligence company for certain Zungui distributors and suppliers. These reports again raised serious issues about Zungui's dealings with its purported distributors and suppliers.

19. During the 2011 Audit, however, E&Y responded to the issues raised by the Hong Kong reports by performing alternative procedures, including an examination of various payments that Zungui had purportedly received from distributors. As a result of these procedures, E&Y obtained additional evidence that raised serious issues about the authenticity of Zungui's transactions with its distributors. Shortly thereafter, E&Y suspended the 2011 Audit, noting that further audit work would not be useful until its concerns were addressed by Zungui.

Collapse of Zungui

20. On August 22, 2011, Zungui's Board of Directors issued a press release announcing that E&Y 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.

21. On August 28, 2011, Zungui's Board of Directors appointed a committee of independent directors to investigate the issues raised by E&Y, but could not obtain sufficient funds from the company's Chinese 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.

22. On September 23, 2011, E&Y resigned as the auditor of Zungui. In its resignation letter, E&Y requested that Zungui take all necessary steps to prevent future reliance on the IPO Auditors' Report or the 2010 Auditors' Report.

23. 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.

Related Commission Proceedings

24. 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.

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

26. 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.

E&Y's Failures to Comply with GAAS

27. As the auditor of Zungui's financial statements, E&Y was required by section 78 of the Securities Act and by National Instruments 41-101 and 52-107 to conduct its audits in accordance with GAAS. To comply with GAAS, E&Y was required to obtain reasonable assurance that Zungui's financial statements were free from material misstatement.

28. However, as set forth below, E&Y failed to obtain reasonable assurance during the IPO Audit because it (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.

A. Failure to Obtain Sufficient Appropriate Audit Evidence

29. GAAS requires an auditor to identify and assess the potential risks of a material misstatement in financial statements due to fraud, and to gather sufficient appropriate evidence to address these risks. In the IPO Audit, E&Y identified risks that Zungui had an incentive to present attractive financial results for the IPO and that the company could inflate its revenue by using fictitious distributors and suppliers.

30. The risk of fictitious distributors and suppliers was a serious fraud risk, as it could affect a substantial part of Zungui's revenue and expenses. To address this risk, E&Y decided to use two specific audit procedures: (i) it would engage Central Business Information Limited ("CBI"), the Hong Kong business intelligence company, to conduct research on Zungui's key distributors and suppliers, and (ii) it would independently confirm Zungui's accounts receivable and accounts payable transaction balances with selected distributors and suppliers.

(i) CBI Reports for Distributors and Suppliers

31. Pursuant to E&Y's direction, CBI conducted research on Zungui's ten largest distributors and three largest original equipment manufacturer ("OEM") suppliers. CBI then provided reports to E&Y regarding the distributors and suppliers that raised a number of significant issues, including the following:

- CBI obtained information indicating that two of Zungui's purported distributors had been established in 2007, but Zungui had reported significant sales to these distributors prior to 2007.

- CBI was unable to contact Zungui's purported 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.
- CBI obtained financial information about five of Zungui's purported distributors, and in each instance the entire amount of inventory purchased by the distributor was significantly lower than the amount of inventory Zungui had supposedly sold to them.
- 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 had purportedly outsourced to them.
- CBI obtained information about the brand names of products distributed by nine of Zungui's purported distributors, and eight of them did not make any reference to the distribution of Zungui's brand.

32. All of the issues raised by the CBI reports called Zungui's dealings with its purported distributors and suppliers into question, and should have prompted E&Y to perform detailed procedures in response. Moreover, the number and pervasiveness of the issues raised by the reports should have also prompted E&Y to reevaluate all of the audit evidence relating to distributors and suppliers and to design new procedures to assess the legitimacy of these entities. Instead, E&Y performed limited additional work and concluded that the CBI reports had established the existence of the researched distributors and suppliers.

(ii) Accounts Receivable and Accounts Payable Confirmations

33. In addition to the CBI reports, E&Y also used a confirmation procedure to address the risk of fictitious distributors and suppliers. To carry out this procedure, E&Y obtained addresses for selected distributors and suppliers from Zungui. E&Y then sent letters (commonly referred to as "confirmations") from Zungui's premises to the addresses provided in order to confirm the distributors' and suppliers' transactions with Zungui.

34. However, multiple confirmations were sent to unverified addresses, incomplete addresses and unspecific addressees – *and yet E&Y still received a “perfect” response in an unusually short timeframe.*

35. Specifically, of the 81 accounts receivable (“AR”) confirmations sent during the IPO Audit:

- 13 were sent to addresses which CBI had been unable to verify;
- 3 were sent to incomplete addresses; and
- 58 were sent to addresses without a named contact person or department.

36. Despite these issues, the AR confirmations yielded an unusually positive response, as all 81 confirmations were returned, confirming the exact transaction balances, with no reconciling items noted. Moreover, nearly all of the confirmations were signed within seven days of their mailing.

37. These issues should have prompted E&Y to consider the quality of the audit evidence obtained from the AR confirmations and reconsider whether this procedure could be relied upon to address the risk of fictitious distributors.

38. Moreover, since both the CBI reports and the AR confirmations raised problematic issues, E&Y was left without sufficient evidence to address the risk of fictitious distributors and suppliers from the very two procedures it had identified to address that risk. In the absence of sufficient evidence, it was critical for E&Y to perform additional procedures to address the fraud risk, but it failed to do so.

B. Failure to Exercise Sufficient Professional Skepticism

39. GAAS requires an auditor to plan and perform audits using professional skepticism, recognizing that circumstances may exist that cause the financial statements to be materially misstated. Professional skepticism is a questioning attitude that is alert to conditions which may indicate possible misstatement due to error or fraud. During the IPO

Audit, however, E&Y encountered problematic evidence on multiple occasions, but failed to skeptically analyze the evidence or its implications.

(i) CBI Reports and Accounts Receivable Confirmations

40. As set forth above, E&Y received reports from CBI regarding certain of Zungui's distributors and suppliers which raised a series of significant issues. E&Y also received a highly unusual response to its AR confirmations. This audit evidence was not only insufficient to address the risk of fictitious distributors and suppliers, but also should have raised E&Y's general concern about the possibility of fraud.

(ii) CBI Report for Zungui

41. E&Y also received a report from CBI regarding Zungui's financial results, detailing revenue and earnings information that was significantly lower than the information that Zungui had provided to E&Y about its revenue and earnings. After receiving this CBI report, E&Y noted that the discrepancy between the Zungui-provided information and CBI-provided information was "huge", but did not perform any procedures to obtain an understanding of the reasons for the discrepancies.

(iii) Zungui Rebates to Distributors

42. E&Y noted that Zungui issued rebates to distributors to reimburse them for expenses incurred in building retail outlets for Zungui products, but there were no invoices available to support any of the rebates. Nevertheless, these rebates were credited against Zungui's purported amounts receivable from the distributors.

(iv) Accounts Payable Confirmations

43. E&Y received an unusually positive response to its accounts payable ("AP") confirmations from suppliers, as 78 of 79 confirmations were returned and confirmed the exact transactions with no reconciling items noted. Moreover, nearly all of the confirmations were also signed within seven days of their mailing.

44. All of the issues set forth above constituted “red flags”, especially in light of the identified fraud risks relating to distributors, suppliers and the incentive to manipulate financial results. These red flags should have caused E&Y to treat the representations from Zungui management with greater caution and to obtain additional audit evidence from independent sources. However, E&Y did not conduct any additional procedures to address these issues.

C. Failure to Conduct Sufficient Review

45. Under GAAS, the Partner, who had overall responsibility for the Zungui engagement, was required to ensure that the IPO Audit was adequately planned, properly supervised and appropriately reviewed. The Partner was specifically required to ensure that sufficient audit evidence was obtained through review of the audit working papers (which documented the procedures performed, audit evidence obtained and conclusions reached) and through discussion with the audit team. In addition, the Partner was required to review documentation for the identified high-risk areas of the audit and any other areas considered to be significant.

46. In the IPO Audit, certain issues should have prompted the Partner to elevate the level and scope of her working paper review, including the following:

- (i) The IPO Audit was a higher risk audit, as it was conducted in preparation for a public listing, involved a foreign-based entity, and identified a risk of fictitious distributors and suppliers.
- (ii) Neither E&Y nor the Partner had ever audited Zungui or had any prior experience working with Zungui prior to the IPO Audit.
- (iii) E&Y’s Manager for the audit, who was the sole reviewer of significant portions of the working papers, was a new employee at E&Y. As noted above, he had never conducted an audit of a China-based company and had never conducted an audit with E&Y or the Partner before. Moreover, the Partner had criticized his level of focus, noting that the Manager showed “a lack of sufficient detail review” of audit

evidence at times.

- (iv) Although the audit evidence included many Chinese-language documents, no member of the audit team senior to the Manager could understand Chinese other than the Partner.
- (v) Although a series of fraud risks had been identified for the IPO Audit, no member of the audit team senior to the Manager had reviewed the work performed to address the fraud risks.

47. Despite the GAAS requirements and the issues identified above, however, the Partner limited her review of the working papers to a review of summary documents and did not review any of the underlying audit evidence.

E&Y's Failures to Comply with GAAS in 2010 Audit

48. As in the IPO Audit, E&Y failed to comply with GAAS in the 2010 Audit because it failed to obtain sufficient appropriate audit evidence, failed to exercise a sufficient level of professional skepticism, and failed to conduct a sufficient review of the audit working papers.

A. Failure to Obtain Sufficient Appropriate Audit Evidence

49. In the 2010 Audit, E&Y identified and assessed the potential risks of material misstatement due to fraud and again identified a risk associated with fictitious distributors and suppliers. Specifically, E&Y identified a risk that Zungui could use fictitious distributors and suppliers or distributor rebates to manipulate its profit margins.

50. To address this fraud risk, E&Y relied on the CBI reports prepared during the IPO Audit, noting that "nothing unusual" was uncovered by the CBI reports and that the reports had established the existence of all top ten distributors. E&Y also reviewed Zungui's calculations of certain distributor rebates, but there were no invoices or independent audit evidence available to support any of the rebates.

51. As a result, E&Y failed to obtain sufficient appropriate audit evidence to address the identified fraud risk.

B. Failure to Exercise Sufficient Professional Skepticism

52. In the 2010 Audit, E&Y encountered recurring red flags related to Zungui's distributors, suppliers and revenue, but failed to skeptically analyze the evidence or its implications.

53. Specifically, E&Y received another unusually positive response to its AR confirmations, as all 33 confirmations sent to distributors were returned and confirmed the exact transactions with no reconciling items noted. E&Y also received a high response rate to its AP confirmations, as all nine confirmations sent to suppliers were returned and confirmed the exact transaction balances with no reconciling items noted. Moreover, nearly all of the AP and AR confirmations were signed within seven days of their mailing.

54. In addition, E&Y continued to rely on its previous analysis of the CBI reports from the IPO Audit, disregarding the multiple issues raised by the reports about Zungui's distributors and suppliers. E&Y also overlooked an unusual consistency in Zungui's top distributor mix, as the percentage of sales for Zungui's top ten distributors were nearly identical during the IPO Audit and 2010 Audit.

55. All of these issues constituted red flags and should have caused E&Y to treat the representations from Zungui management with greater caution and to obtain additional audit evidence from independent sources. However, E&Y did not conduct any additional procedures to respond to the red flags.

C. Failure to Conduct Sufficient Review

56. Finally, the Partner again limited her review of the audit working papers to a review of summary documents for the 2010 Audit, and again failed to review any of the underlying audit evidence.

57. This review failure was particularly problematic in light of the fraud risks identified in the audit and the fact that the same Manager was once again the sole reviewer of significant areas of audit work.

Breaches of Ontario Securities Law

58. E&Y's failures to comply with GAAS in the IPO Audit and 2010 Audit, as outlined above, led it to overlook or discount significant issues that called the accuracy of Zungui's financial statements into question.

59. Each of E&Y's failures to comply with GAAS requirements during the IPO Audit constituted a breach of National Instruments 41-101 and 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.

60. In addition, each document filed with the Commission in which E&Y represented that the IPO Audit and 2010 Audit had been conducted in accordance with GAAS constituted a breach of section 122(1)(b) of the Securities Act.

61. The audit failures of E&Y outlined above also constituted conduct contrary to the public interest.

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

DATED at Toronto, Ontario, this 24th day of June, 2013.