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
BDO CANADA LLP**

## AMENDED STATEMENT OF ALLEGATIONS

**(Subsection 127(1) and section 127.1 of the *Securities Act*, RSO 1990, c S.5)**

### A. ORDER SOUGHT

Staff ("**Enforcement Staff**") of the Enforcement Branch of the Ontario Securities Commission (the "**Commission**") request that the Commission make an order, ordering:

1. that BDO Canada LLP ("**BDO**") be reprimanded, pursuant to paragraph 6 of subsection 127(1) of the *Securities Act*, RSO 1990, c S.5 (the "**Act**");

2. that BDO pay an administrative penalty of not more than $1 million for each failure by BDO to comply with Ontario securities law, pursuant to paragraph 9 of subsection 127(1) of the Act;

3. that BDO disgorge to the Commission any amounts obtained as a result of the non-compliance with Ontario securities law, pursuant to paragraph 10 of subsection 127(1) of the Act;

4. that BDO pay the costs of the Commission investigation and hearing, pursuant to section 127.1 of the Act; and

5. such other order as the Commission considers appropriate in the public interest.

## B. FACTS

Enforcement Staff make the following allegations of fact:

### I. Overview

1. As gatekeepers, auditors contribute to public confidence in the integrity of financial reporting, a cornerstone of our capital markets. In conducting audits of financial statements and reporting thereon, it is critical that auditors comply with generally accepted auditing standards. When an auditor issues an unmodified audit opinion on an entity's financial statements, the auditor provides assurance that the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles. As such, auditors play an important role in investor protection and the framework for proper disclosure is undermined when they fail to adequately carry out their role.

2. Between ~~1998~~at least 2005 and 2017, BDO was the auditor of Crystal Wealth Management Systems Limited ("**Crystal Wealth**") and the investment funds managed by it at the time (the "**Crystal Wealth Funds**"). In April 2017, on application by the Commission, Crystal Wealth, the Crystal Wealth Funds and their directing mind, Clayton Smith ("**Smith**"), were put into receivership by the Ontario Superior Court of Justice. The Commission subsequently approved a settlement agreement between Smith and Enforcement Staff in which Smith admitted to fraud on two Crystal Wealth Funds—Crystal Wealth Media Strategy (the "**Media Fund**") and Crystal Wealth Mortgage Strategy (the "**Mortgage Fund**" and, together with the Media Fund, the "**Funds**" and each, a "**Fund**"). Certain of the fraudulent investments were recorded in the Funds' financial statements audited by BDO.

3. BDO audited the Funds' financial statements as at and for the years ended December 31, 2014 and December 31, 2015. In those financial statements, the Media Fund and Mortgage Fund were valued at approximately $50 million and $40 million, respectively. In each auditor's report accompanying those financial statements, BDO represented to the Fund's unitholders that it had performed its audit (each, an "**Audit**") in accordance with Canadian generally accepted auditing standards ("**GAAS**").

4. That representation was false. BDO did not conduct its Audits in accordance with GAAS. It failed to do so in three principal ways.

5. First, BDO did not obtain sufficient appropriate audit evidence of the existence and valuation of the Funds' assets. To begin, BDO did not perform all the retrospective reviews for accounting estimates required by GAAS. Without those reviews, BDO could not design audit procedures responsive to the risk that the financial statements were materially misstated. Next, in completing the audit procedures it did design, BDO unduly relied on the Funds' service providers—who were not independent of Smith—and on Smith himself. Finally, even though BDO identified a material misstatement in the Media Fund's 2015 financial statements, it provided an unmodified audit opinion on them.

6. BDO's second principal violation of GAAS was its failure to undertake its work with sufficient professional skepticism. Throughout the Audits, BDO disregarded contradictory audit evidence and other circumstances that could be indicative of fraud. BDO failed to recognize the resultant, increased risk of material misstatement and did not address the heightened risk with enhanced audit procedures. The enhanced procedures would have resulted in BDO obtaining additional evidence before determining whether it could issue unmodified audit opinions on the financial statements.

7. Last, before issuing its audit opinions, BDO did not complete the engagement quality control reviews ("**EQCRs**") of the Audits that it had determined were required.

8. By falsely stating in each auditor's report that it had conducted the Audit in accordance with GAAS, BDO breached subsection 122(1)(b) of the Act. In addition, each of BDO's failures to comply with GAAS violated subsection 78(3) of the Act.

## II. <u>Background</u>

9. The Funds were privately-offered mutual fund trusts managed by Crystal Wealth, a Burlington, Ontario-based corporation. Crystal Wealth also acted as the Funds' trustee, portfolio manager and promoter.

10. Smith was Crystal Wealth's founder, principal shareholder, directing mind and sole director and officer. He acted as Crystal Wealth's President, Chief Executive Officer, Chief Financial Officer and Chief Compliance Officer and was BDO's principal point of contact during the Audits.

11. BDO is a limited liability partnership, the head office of which is in Toronto, Ontario. It has more than 125 offices across Canada and is part of the international BDO network of independent member firms.

12. By 2005, BDO ~~was first~~had been appointed auditor of Crystal Wealth and the Crystal Wealth Funds~~ in 1998.~~. It audited the Funds' 2014 and 2015 financial statements.

13. BDO was also engaged to audit the Funds' 2016 financial statements. At the time of those audits, BDO was aware of Enforcement Staff's investigation in this matter. In the audits, BDO introduced new procedures, such as seeking additional evidence from sources independent of the Funds and Smith. BDO was not able to complete the procedures or issue auditor's reports on the Funds' financial statements by March 31, 2017, when they were due to be delivered to unitholders.

14. Thereafter, on April 6, 2017, on application by Enforcement Staff, the Commission ordered that all trading in securities of the Crystal Wealth Funds cease. On April 26, 2017, on application by the Commission, the Ontario Superior Court of Justice appointed Grant Thornton Limited receiver and manager of the assets of the Crystal Wealth Funds, Crystal Wealth and Smith, personally.

15. On June 13, 2018, the Commission approved a settlement agreement between Enforcement Staff and Smith. In the settlement agreement, Smith admitted to fraud relating to investments recorded in the Media Fund's 2014 and 2015 financial statements and the Mortgage Fund's 2015 financial statements, all of which had been audited by BDO.

## III. BDO's Obligations as Auditor

16. As auditor of the Funds' 2014 and 2015 financial statements, BDO was subject to provisions of Ontario securities law such as subsections 122(1)(b) and 78(3) of the Act.

17. The Funds' financial statements were required to be delivered to unitholders under National Instrument 81-106 *Investment Fund Continuous Disclosure* ("**NI 81-106**"). Because the financial statements were audited, subsection 2.7(3) of NI 81-106 mandated that they be accompanied by an auditor's report prepared in accordance with GAAS. The Funds' audited financial statements were posted on Crystal Wealth's website.

18. BDO's auditor's reports on the Funds' 2014 and 2015 financial statements were dated March 31, 2015 and March 31, 2016, respectively, and were addressed to the Funds' unitholders. In each auditor's report, BDO represented that it had conducted its Audit in accordance with GAAS. That was not true. In making these false representations, BDO breached GAAS and subsection 2.7(3) of NI 81-106. BDO also violated subsection 122(1)(b) of the Act. Subsection 122(1)(b) prohibited BDO from making materially misleading statements in reports or other documents required to be furnished or filed under Ontario securities law.

19. Under subsections 78(1) and (2) of the Act, the Funds' 2014 and 2015 financial statements, together with BDO's auditor's reports, were required to be filed with the Commission. Subsection 78(3) of the Act required BDO to make the examinations necessary to prepare its auditor's reports in accordance with GAAS. BDO failed to do so.

20. The principal auditing standards BDO failed to comply with are set forth in Part IV below. Part V details BDO's non-compliance with GAAS.

## IV. Generally Accepted Auditing Standards

21. As the basis for the auditor's opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements are free from material misstatement. Reasonable assurance is a high level of assurance.

22. To obtain reasonable assurance, GAAS set out various standards to be met, requirements to be fulfilled and steps to be taken. They include obtaining sufficient appropriate audit evidence, exercising professional skepticism and completing EQCRs in accordance with GAAS.

### (A) Sufficient Appropriate Audit Evidence Required

23. To obtain reasonable assurance, the auditor must obtain sufficient appropriate audit evidence to reduce, to an acceptably low level, the risk of incorrectly opining on misstated financial statements.

#### *(1) The Need for Retrospective Reviews*

24. To assess the risk of material misstatement, the auditor must perform a retrospective review of the outcomes of accounting estimates included in the prior financial statements. Retrospective reviews assist in assessing whether the current estimates are misstated and in identifying any indications of management bias that might represent a risk of material misstatement due to fraud.

#### *(2) The Need for Independent Evidence*

25. The higher the assessed risk of material misstatement, the more persuasive the required audit evidence. Generally, evidence from independent sources outside the audited entity is more reliable than evidence from the entity.

#### *(3) The Need for Assurance about Service Organization Controls*

26. A service organization is a service provider whose services are part of the audited entity's financial reporting information systems. When an audited entity uses a service organization, transactions that affect its financial statements become subject to the service organization's controls. If the auditor obtains evidence from the service organization, the auditor cannot simply assume that the service organization's related controls operate effectively. It must obtain evidence about their effectiveness by testing the controls directly or obtaining an appropriate report on them.

#### *(4) The Need to Address Inconsistencies and Obtain Sufficient Appropriate Audit Evidence*

27. Determining what procedures are required to complete an audit is a dynamic process that must be responsive to any changes in the auditor's assessment of the risk of material misstatement. For example, if evidence from two sources is inconsistent, the auditor must determine what changes to its planned procedures are necessary to resolve the matter. If the

auditor cannot obtain sufficient appropriate evidence of a material item, the auditor must not provide an unmodified opinion on the financial statements.

#### *(5) The Need to Respond to Misstatements*

28. If the auditor identifies a misstatement, it must determine whether the misstatement is indicative of fraud. If it is, the auditor must evaluate the implications for the audit, including the reliability of management representations, recognizing that an instance of fraud is unlikely to be an isolated occurrence. If the auditor concludes that the financial statements are not free from material misstatement, the auditor must not provide an unmodified opinion on them.

#### *(6) The Need to Document the Audit*

29. Audit documentation is the record of the audit procedures performed, relevant audit evidence obtained and conclusions reached. A principal purpose of audit documentation is to evidence that the audit was planned and performed in accordance with GAAS. The audit documentation must provide evidence of the auditor's basis for conclusions about critical matters such as whether the auditor has obtained reasonable assurance that the financial statements are free from material misstatement. The audit documentation for an engagement must be assembled in the audit file for that engagement.

### (B) Professional Skepticism Required

30. The auditor must plan and perform its audit with professional skepticism, recognizing that circumstances may cause the financial statements to be materially misstated. Professional skepticism requires a questioning mind and a critical assessment of the audit evidence. It includes alertness to contradictory audit evidence, information that brings the reliability of documents into question and conditions that may indicate fraud, such as missing evidence.

### (C) Engagement Quality Control Reviews Required

31. If the auditor determines that an EQCR is required, the EQCR must be performed before the auditor's report is completed. An EQCR is an objective evaluation of the engagement team's significant judgments and conclusions. The EQCR reviewer cannot be part of the engagement team.

## V. BDO's Failures to Comply with Generally Accepted Auditing Standards

32. BDO's Audits failed to comply with GAAS due to a lack of sufficient appropriate audit evidence, professional skepticism and EQCRs.

### (A) Lack of Sufficient Appropriate Audit Evidence

33. BDO did not obtain sufficient appropriate audit evidence of the existence and valuation of the significant assets recorded in the Media Fund's and the Mortgage Fund's 2014 and 2015 financial statements.

#### *(1) Media Fund*

(a) Background to the Fund[1]

34. In the 2014 and 2015 financial statements, the Media Fund was valued at approximately $50 million. The Fund primarily invested in asset-backed debt obligations ("**Loans**") of motion picture and series television productions. The Loans were to finance the production projects. In 2014 and 2015, approximately 25 Loans represented 85% of the Fund's assets.

35. Media House Capital (Canada) Corp. ("**MHC**") was retained by the Fund to conduct due diligence on potential Loan investments and present them to the Fund for purchase. If the Fund acquired a Loan, MHC was to manage and service it, including collecting principal and interest payments for the Fund. MHC received an upfront fee of up to 10% of the value of the Loans it sold to the Fund. The Fund purchased Loans from MHC on an ongoing basis.

(b) BDO's Failure to Adequately Address Existence of Loans

36. BDO did not obtain sufficient appropriate evidence of the existence of the Loans. Its planned procedures were to confirm all the Loans with MHC, whether they had been acquired in the current or previous years. In addition, BDO planned to review the "loan agreements" for Loans ("**New Loans**") purchased in the current year.

37. It was not appropriate for BDO to rely on a confirmation from MHC. First, given MHC's business relationships with the Fund and Smith, it was not an independent, objective source of

[1] The description of the Fund and its operations is based on BDO's audit documentation.

information about the Loans. Further, BDO did not adequately assess whether MHC was a service organization in the 2014 Audit and did not take ~~any of the~~ other steps required by GAAS when service organizations are involved in either Audit. MHC was to record information about the Loans for the Fund, but there was nothing inherently reliable about MHC's records or related confirmations. Nonetheless, BDO did not obtain assurance about the controls relevant to the audit evidence provided by MHC.

38. In addition, there were three significant deficiencies in the "loan agreements" BDO obtained for the New Loans. First, they were not agreements between the borrower—the production company—and the lender—the Fund. Instead, BDO obtained two types of documents ("**Loan Documents**"): (a) purchase notices, each of which was a notice from the Fund to MHC that it wished to purchase a Loan; and (b) supplements, each of which evidenced MHC's sale of a Loan to the Fund. The Loan Documents did not provide any evidence of the borrowers' obligations to the Fund.

39. Second, BDO did not obtain a complete set of Loan Documents for every New Loan. Purchase notices were unaccompanied by supplements and many of the supplements were only partially executed.

40. Third, even though information in many Loan Documents was inconsistent with other audit evidence, BDO did not enhance its procedures to properly resolve the discrepancies. For instance, various Loan Documents set forth principal amounts that differed from those in MHC's confirmations. Yet in its Audits, BDO identified and performed procedures on ~~only~~few of the inconsistencies and, in one ~~inconsistency. In that~~ case, ~~BDO~~ relied solely on information from Smith, rather than independent evidence.

41. The audit files also included a variety of Loan Documents and promissory notes for Loans purchased in previous years. There were also numerous issues with this documentation. First, it was incomplete. For instance, purchase notices were not accompanied by corresponding supplements. Second, much of the documentation was not fully executed. Third, the information about a Loan often differed within the documentation and as between the documentation and MHC's confirmations, including in areas such as principal amount. These deficiencies in the

Loan documentation should have prompted BDO to perform further procedures. BDO failed to do so.

(c) <u>BDO's Failure to Adequately Address Valuation of Loans</u>

42. BDO also failed to appropriately verify Smith's valuation of the Loans.

43. The value of the Loans turned on the probability of collecting on them. That probability depended on the sales of the productions to be financed by the Loans. As a result, forecasts of those sales ("**Sales Forecasts**") were critical to determining the value of the Loans. In the 2014 and 2015 Audits, BDO relied on Sales Forecasts that it stated had been confirmed by, or obtained from, MHC.

44. BDO's procedures for auditing Smith's Loan valuations and its responses to the results of those procedures did not comply with GAAS.

*<u>2014 Audit</u>*

45. In the 2014 Audit, BDO failed to conduct the required retrospective review of Smith's 2013 Loan valuation and inappropriately relied on an analysis from BDO's valuations group.

46. First, because BDO did not complete a retrospective review of Smith's 2013 Loan valuation, it could not determine whether there was an increased risk of material misstatement due to fraud. BDO's audit documentation included a checklist (the "**Fraud Checklist**") to assist its engagement team in complying with the GAAS requirements on fraud. The Fraud Checklist required retrospective reviews of significant accounting estimates and a determination of whether differences between the estimates and the actual results indicated management bias. BDO completed the Fraud Checklist by stating that no retrospective reviews were necessary because there were no significant accounting estimates. Yet in other audit documentation, BDO recognized that the value of the Loans was a significant accounting estimate.

47. Second, in evaluating Smith's 2014 Loan valuation, BDO improperly relied on an analysis from its valuations group. The valuations group's analysis was based on Sales Forecasts, the appropriateness and reliability of which were to be assessed with a confirmation from MHC. The audit file, however, contained no such confirmation of the Sales Forecasts. Moreover, as

described above, MHC was not an independent, objective source of information about the Loans and BDO obtained no assurance about its controls.

<u>*2015 Audit*</u>

48. In the 2015 Audit, BDO failed to comply with GAAS in its retrospective review of Smith's 2014 Loan valuation and in its audit of Smith's 2015 Loan valuation.

*(i) Deficient Retrospective Review of Smith's 2014 Loan Valuation*

49. BDO's retrospective review in the 2015 Audit was problematic for two principal reasons: its procedures were flawed and its response to the results of those procedures was inadequate.

50. In its retrospective review, BDO compared Smith's 2014 forecast of expected receipts on the Loans with the amounts collected on the Loans in 2015 and early 2016. In determining the amounts collected in 2015, BDO solely relied on the Fund's accounting records. BDO did not corroborate the Fund's records with independent evidence, such as bank records.

51. The results of BDO's analysis revealed that the 2014 forecast of receipts, when compared to amounts collected by early 2016, fell short by almost 80% or $25 million. The shortfall was approximately half the value of the Fund.

52. Notwithstanding its magnitude, BDO concluded that the shortfall appeared "to be largely due to timing" and noted that Smith was revising his current estimates. BDO did not consider whether the shortfall represented a risk of material misstatement due to fraud in the 2015 financial statements it was auditing.

*(ii) Deficient Audit of Smith's 2015 Loan Valuation*

53. BDO's procedures relating to Smith's 2015 Loan valuation were deficient in terms of both the steps that BDO took and BDO's response to the results. To evaluate Smith's 2015 Loan valuation, BDO developed its own Loan valuation.

54. Both Smith's and BDO's valuations depended on Sales Forecasts from MHC. BDO's procedures to determine the appropriateness of the Sales Forecasts were inadequate. They

consisted of conducting the flawed retrospective review described above and obtaining oral representations from MHC, the organization that had provided the Sales Forecasts.

55. In BDO's Loan valuation, BDO came to a single estimate of the value of the Loans (the "**BDO Value**") of $47 million. To calculate the BDO Value, BDO added what it determined was the "most likely" value of each Loan to $1.5 million in respect of a guarantee from MHC.

56. There were several issues with BDO's calculation of the BDO Value. First, BDO did not follow the methodology it stated it used to determine the "most likely" value of each Loan. Instead, in determining the "most likely" value of each Loan, BDO often arrived at values for the Loans that were greater than what had been recorded as owing on the Loans. The result was an inappropriate increase in the BDO Value of $1.4 million.

57. BDO also should not have included the amount of the guarantee in the BDO Value. The guarantee consisted of a letter dated March 31, 2016, in which MHC stated that it would pay a "recoupable" $1.5 million towards the Fund, for any losses above and beyond the Fund's accrued loan-loss provisions. Aside from its "recoupable" nature, the guarantee was not in effect at the date of the financial statements. The result was a further, inappropriate increase in the BDO Value of $1.5 million.

58. Finally, although BDO determined that an analysis from its valuations group was required to value the Loans, BDO finalized the BDO Value without that analysis. According to the audit documentation, the valuations group's analysis would be, and was, provided in report form. But there were no reports, or any other evidence of the valuations group's steps, in the audit file.

59. The BDO Value was approximately $3 million less than Smith's Loan value. The difference between the BDO Value and Smith's Loan value would have been twice the size—approximately $6 million—had BDO not inappropriately increased the BDO Value.

60. GAAS required BDO to ask Smith to correct his Loan value. Two days before the date of its auditor's report, BDO sent Smith an interim, working copy of its Loan valuation. In the covering email, BDO wrote: "The numbers may not make sense at the moment but I'm hoping we can clarify a few things/I can let you know our thought process and we can meet somewhere

in the middle." The $3 million was ultimately disclosed in a note to the financial statements as a "potential change" in Smith's Loan value.

61. Meanwhile, Smith's Loan value appeared in the body of the financial statements. This was a misstatement. In responding to the misstatement, BDO did not take the steps required by GAAS, such as determining whether the misstatement was indicative of fraud.

62. The misstatement—be it BDO's calculated amount of $3 million or the more appropriate $6 million—was material. Despite the inclusion of a material misstatement in the financial statements, BDO gave an unmodified opinion on them in its auditor's report.

### *(2) Mortgage Fund*

#### (a) <u>Background to the Fund</u>[2]

63. In the 2014 and 2015 financial statements, the recorded value of the Mortgage Fund was $40 million and $44 million, respectively. The Fund primarily invested in residential mortgages in Canada. In 2014 and 2015, the Fund held ~~approximately 335~~<u>over 300</u> residential mortgages constituting 83% and 63% of its assets, respectively. The Fund also held commercial mortgages and commercial loans. In connection with its investments, the Fund engaged several service providers.

64. Spectrum-Canada Capital (2002) Corporation and Spectrum-Canada Mortgage Services Inc. (collectively, "**Spectrum**") was the principal seller of residential mortgages to the Fund. Like MHC, Spectrum was to evaluate investments in accordance with due diligence guidelines and present them to the Fund for potential purchase. Once the Fund purchased a mortgage from Spectrum, Spectrum managed and serviced it. Among other things, Spectrum held a bank account for mortgage payments and provided reports on which the Fund's records were based. Spectrum's fees were based on the Fund's outstanding advances on the mortgages. The Fund purchased mortgages from Spectrum on an ongoing basis.

[2] The description of the Fund and its operations is based on BDO's audit documentation.

65. Other of the Fund’s residential mortgages were administered by Squire Management Inc. (“**Squire**”). Like Spectrum, Squire held a bank account into which mortgage payments were deposited and sent Smith weekly reports summarizing all mortgages and payments.

66. Liberty Mortgage Services Ltd. (“**Liberty**”) dealt with the Fund’s commercial mortgages. Like Spectrum, Liberty sold the Fund mortgages it held that met the Fund’s criteria. The Fund recorded the mortgages in its books based on Liberty’s weekly reports.

### (b) BDO’s Failure to Adequately Address Existence of Mortgages

67. BDO did not obtain sufficient appropriate evidence of the existence of the mortgages. In performing its procedures, BDO inappropriately relied on audit evidence from Spectrum, Squire and Liberty (collectively, the “**Service Providers**”) and failed to properly test the audit evidence it obtained.

#### *Insufficient Independent Evidence*

68. BDO inappropriately relied on the Service Providers in confirming and testing the mortgages.

69. First, Spectrum ~~and Liberty were~~was not an independent, objective ~~sources~~source of information about the mortgages, given ~~their~~its relationships with the Fund and Smith.

70. Second, BDO did not adequately evaluate whether ~~the Service Providers were service organizations or take the~~ Spectrum was a service organization in the 2014 Audit. In neither Audit did BDO take other steps required by GAAS when dealing with service organizations. For example, BDO did not consider how the Service Providers’ involvement in the Fund’s transactions and accounting affected the Fund’s controls. As a result, BDO was not in a position to identify, assess and respond to the risk of material misstatement.

71. Finally, although the Service Providers were to note information about the Fund’s mortgage loans in the records they maintained for the Fund, nothing about their records or related confirmations was inherently reliable. Nonetheless, BDO performed no procedures to obtain assurance about the effectiveness of their related controls.

*Deficient Testing*

72. BDO's approach to testing the new mortgages was deficient at both the sampling and testing stages.

73. To start, in sampling the new residential mortgages to be tested in its 2014 Audit, BDO assessed overall risk as "low/normal" because Spectrum administered the mortgages. In making this assessment, BDO did not identify any of the issues with Spectrum's independence described above or explain why Spectrum's involvement reduced the risk. The lower risk assessment resulted in a smaller sample size and thus less reliable test results.

74. To test the selected mortgages, in each Audit, BDO stated that it had compared information in a listing of new mortgages provided by Smith against information in mortgage files. However, BDO's documentation of its review of the mortgage files was deficient. The audit files did not provide sufficient evidence that BDO performed procedures to confirm key mortgage details such as property location, term and interest rate.

75. Last, in the 2014 audit file, Smith's listing of initial loan amounts differed from the information in Spectrum's confirmation. BDO neither identified the discrepancies nor performed procedures to reconcile them.

(c) BDO's Failure to Adequately Address Valuation of Mortgages and Commercial Loans

76. BDO's audits of Smith's valuations of the Fund's mortgages and commercial loans were also inadequate.

*Deficient Audit of Smith's Mortgage Valuation*

77. BDO's mortgage valuation work was deficient with respect to retrospective reviews and sufficient appropriate audit evidence.

78. In its 2014 Audit, BDO did not perform a retrospective review on the accrued loss provision on the mortgages—an essential component in their value. Without this review, BDO could not assess whether there was a heightened risk of material misstatement due to fraud. On the Fraud Checklist that required this analysis, BDO indicated that no retrospective review was

required because there were no significant accounting estimates. Yet in other audit documentation, BDO recognized that the accrued loss provision on the mortgages was a significant accounting estimate.

79. In addition, BDO did not obtain the evidence required to verify Smith's estimated accrued loss provision in either Audit. To start, BDO relied on evidence from the Service Providers, despite the issues discussed in paragraphs 68 through 71 above. Further, in the 2014 Audit, to determine which commercial mortgages were in arrears, BDO relied solely on Smith. BDO did not corroborate the completeness of Smith's listing of mortgages in arrears with any independent evidence.

*Deficient Audit of Smith's Commercial Loan Valuation*

80. BDO's audit work on Smith's 2015 commercial loan valuation was also deficient.

81. To audit Smith's 2015 valuation, BDO developed its own valuation. BDO's valuation did not consider the probability of collecting on the commercial loans held by the Mortgage Fund. For example, one of the commercial loans was a Loan on a media production that the Mortgage Fund had acquired from MHC. BDO did not consider Sales Forecasts in valuing that Loan, even though BDO had determined in its Media Fund Audits that Sales Forecasts were critical to the Loan valuation.

82. In its working papers, BDO indicated that there was a memorandum explaining its methodology for valuing the commercial loans. But there was no such memorandum or other explanation of BDO's approach to valuing the commercial loans in the audit file.

83. Because of all the deficiencies described above, BDO's Audits of the Mortgage Fund's 2014 and 2015 financial statements did not comply with GAAS.

**(B) Lack of Professional Skepticism**

84. BDO did not conduct its Audits with sufficient professional skepticism. As described above, BDO had notice of many unusual facts which should have caused it to treat Smith's representations with greater caution, obtain additional evidence from independent sources and perform additional procedures on that evidence. BDO did not do any of this.

### (C) Lack of Engagement Quality Control Reviews

85. BDO also did not complete EQCRs on any of the Audits, even though it had determined that they were required on all of them. Although BDO indicated in its audit documentation for each of the Audits that one of its partners had acted as EQCR reviewer, that partner could not conduct an EQCR under GAAS because he was a member of the engagement team. Other documentation in each audit file confirmed that no EQCR had been completed.

## C. BREACHES AND CONDUCT CONTRARY TO THE PUBLIC INTEREST

Enforcement Staff allege the following breaches of Ontario securities law and conduct contrary to the public interest:

1. each of BDO's representations in its auditor's reports that the relevant Audit had been conducted in accordance with GAAS constitutes a materially misleading statement contrary to subsection 122(1)(b) of the Act;

2. each of BDO's failures to comply with GAAS in auditing the Funds' 2014 and 2015 financial statements constitutes a breach of subsection 78(3) of the Act; and

3. further and in any event, the conduct described above is contrary to the public interest.

Enforcement Staff reserve the right to amend these allegations and to make such further and other allegations as Enforcement Staff deem fit and the Commission may permit.

**DATED** this ~~12~~16th day of ~~October, 2018.~~September, 2019.

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