

BETWEEN:

ONTARIO SECURITIES COMMISSION

(Applicant)

- and -

KPMG LLP

(Respondent)

APPLICATION FOR ENFORCEMENT PROCEEDING

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

A. OVERVIEW

1. This proceeding highlights the importance of audited financial statements to investors in the capital markets. Audited financial statements for investment vehicles enhance the credibility of those vehicles, attracting and building trust with investors, and assuring investors that they have a true and fair view of the investment's financial condition. It is crucial for the integrity of capital markets that audits comply with generally accepted auditing standards.

2. KPMG LLP was engaged to be the independent auditor for the financial statements of four funds managed by Bridging Finance Inc. for the fiscal years ended December 31, 2019 and December 31, 2020. For each of the eight audits, KPMG issued an independent auditor's report directed to the unitholders of each fund, stating KPMG's opinion that the financial statements presented fairly, in all material respects, the financial position of the respective fund. In each of the eight auditor's reports, KPMG represented to fund unitholders that KPMG had conducted its audits in accordance with Canadian generally accepted auditing standards. These representations were false.

3. KPMG failed to perform fundamental audit procedures over the most critical aspect of the financial statements – the valuation of the loans held within each of the funds. Without sufficient appropriate audit evidence over the valuation of loans, an audit of funds comprised of loans is

flawed. KPMG did not obtain sufficient audit evidence to support the audit opinions that KPMG issued.

4. KPMG failed to conduct its audit work with an adequate degree of professional skepticism by failing to consistently challenge and validate audit evidence it gathered. KPMG failed to subject Bridging Finance management's judgments and estimates to effective scrutiny, even where those judgements and estimates appeared unreasonable and suggested potential management bias.

5. KPMG failed to consider, adequately or at all, the audit implications of evidence that methodologies used by Bridging Finance to value the loans in its portfolio were unreliable and that the collective value of the loans could be materially overstated. When KPMG identified that certain loans were overstated, KPMG inappropriately assumed that those findings were isolated to those loans, without considering whether those findings were in fact indicators of material overstatements of the overall balance of the loans contained within the funds whose financial statements KPMG audited.

6. KPMG failed to gather sufficient appropriate audit evidence to support its opinions that the financial statements were representative of the true financial position of the funds. Had KPMG expanded the depth and scope of its testing, it would likely have discovered significant, material misstatements in the financial statements of the funds.

7. KPMG's actions had consequences for investors, who bought units of the funds at inflated prices and made investment decisions regarding their positions that they may not otherwise have made.

8. In addition, KPMG's representations that it had audited the funds in accordance with Canadian generally accepted auditing standards would have given investors a false sense of confidence in the funds' financial statements and in the value of their investment.

9. As gatekeepers, auditors contribute to public confidence in the integrity of financial reporting, a cornerstone of Ontario's capital markets. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements being audited. In conducting audits of financial statements and reporting thereon, it is critical that auditors comply with generally accepted auditing standards. Auditors who falsely represent that they have complied with those standards harm investors and undermine the framework for proper disclosure and therefore undermine the public interest.

B. GROUNDNS

The Commission makes the following allegations of fact.

(I) The Bridging Funds

10. Bridging Finance Inc. (**BFI**) was an investment management firm based in Toronto and founded in 2012. BFI managed certain privately issued investment vehicles. These included four BFI funds whose financial statements were audited by KPMG in 2019 and 2020 (the **Four Funds**).¹ The Four Funds reported a collective net asset value (**NAV**) of approximately \$1.7 billion at both December 31, 2019 and 2020.

11. The Four Funds raised money from investors who purchased units of the Four Funds (the **Unitholders**). Units in the Four Funds were sold without a prospectus, to accredited investors only.

12. Subscriptions for new units of the Four Funds could be made on the last business day of each month (**Valuation Date**), with an unlimited number of eligible subscribers. Redemptions of units could be made at the NAV per unit on a Valuation Date and at other times for certain funds, subject in certain cases to acceptance by the general partner of the applicable fund.

13. Investors purchased and redeemed units of the Four Funds before and after the issuance of KPMG's auditor's reports for the financial statements of the Four Funds for 2019 and 2020.

14. Investor money was used to originate loans (the **Loan Portfolio**). The Loan Portfolio was syndicated across one or more funds, including the Four Funds. Most of the loans were issued to Canadian companies unable to secure financing from traditional lenders.

15. For each of the Four Funds, the NAV of the fund represented the aggregate fair market value of the assets of the fund, including the portion of the Loan Portfolio allocated to that fund, cash and receivables, less total liabilities of the fund, with all values determined by BFI. The portion of

¹ The four Bridging Funds audited by KPMG were: the Bridging Income Fund LP, the Bridging Mid-Market Debt Fund LP, the Bridging Private Debt Institutional LP and the Bridging Indigenous Impact Fund.

the Loan Portfolio allocated to the Four Funds constituted approximately 80% of the Four Funds' aggregate NAV.

16. For the relevant audit years, the Loan Portfolio was comprised of approximately seventy loans to borrowers across various industries, including manufacturing, financial services, consumer retail, real estate, and cannabis. The Loan Portfolio included unique loans requiring special consideration from an audit and valuation perspective.

17. There were multiple risks embedded in the Loan Portfolio, including the following.

- (a) BFI's business model involved lending to higher-risk companies as compared to traditional lenders and charging a higher rate of interest in return. The higher interest rate was meant to compensate for the higher risk of the loan.
- (b) A number of loans were set up so that interest would be "paid-in-kind" (**PIK**), meaning interest that accrued on the loan would be added to the balance of the loan repayable on maturity rather than paid in cash at intervals through the life of the loan. This allowed BFI to record interest accruals as revenue while not collecting any cash. While some loans were structured as PIK loans from the start, others were converted into PIK loans later as borrowers failed to make interest payments.
- (c) As particularized below, when certain loans were in arrears (including for more than 90 days), BFI restructured the loan, including through extending the term of the loan, adding uncollected accrued interest to the balance of the loan, and/or increasing the principal amount of the loan.
- (d) BFI was a closely-held private company with a small senior management team, including related family members (**BFI Management**).
- (e) BFI Management exercised significant discretion and judgment in approving loans, assessing the collateral provided for loans, and valuing the loans held by the Four Funds. BFI Management therefore had the opportunity to inflate NAV by inflating the value of the loans. They also had the incentive to do so, as BFI was compensated from the Four Funds through management and incentive fees, both derived from NAV.

18. For each loan in the Loan Portfolio, BFI calculated the loan value by recording the book value of each loan (the principal amount of the loan plus any accrued interest), minus the expected credit loss (the **ECL**) for each loan.

19. For each loan in the Loan Portfolio, BFI applied an ECL estimation process which included a mathematical formula to calculate its ECL (the **ECL Model**): the book value of each loan (outstanding principal plus accumulated accrued interest) was multiplied by the percentage of Loss Given Default (**LGD**) and the percentage of probability of default (**PD**).

(a) For calculating LGD (used to estimate the loss on a loan's collateral in the event of default), BFI used external LGD data obtained from Schedule 1 banks to estimate the anticipated losses on each category of collateral assets for which such data was available. For categories of collateral assets for which this data was not available (such as promissory notes and personal guarantees from individuals associated with a borrower), BFI simply determined its own LGD rates.

(b) For estimating the PD (defined as "the probability that a borrower or account will default within a performance period"), BFI used global corporate default rates from third-party rating agencies including Standard & Poor's and Moody's (collectively, **Rating Agencies**) based upon the borrower's industry of operation. BFI used the Rating Agencies' average default rate plus the Rating Agencies' standard deviation, intended to reflect the higher credit risk within the Four Funds' Loan Portfolio. In addition, BFI multiplied the total Rating Agencies' default rate by a subjective factor between 1 and 10, which was intended to reflect the unique credit risks of each loan, as assessed by BFI Management.

20. The ECL calculated by BFI for each loan had a direct impact on the net book value of that loan. The net book value of the loan had an impact on the NAV of any fund to which that loan belonged. A lower ECL would result in a higher NAV, and a higher ECL would result in a lower NAV. A higher NAV could drive higher management and incentive fees earned by BFI and charged to Unitholders of the Four Funds.

(II) Generally Accepted Auditing Standards

21. In Canada, Canadian Auditing Standards (CAS) constitute generally accepted auditing standards (GAAS). CAS are modelled on the International Standards on Auditing issued by the International Auditing and Assurance Standards Board.

22. 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.

23. An audit conducted in accordance with GAAS requires an auditor to:

- (a) plan and perform the audit to obtain reasonable assurance that the financial statements, as a whole, are free from material misstatement, whether due to fraud or error;
- (b) obtain sufficient appropriate audit evidence, on a test basis, supporting the amounts and disclosures in the financial statements;
- (c) evaluate the appropriateness of the accounting principles used and the reasonableness of significant accounting estimates made by management; and
- (d) evaluate the overall financial statement presentation.

24. To conduct an audit in accordance with GAAS, the auditor seeks reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. "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.

25. GAAS requires that an auditor must conclude whether sufficient and appropriate audit evidence has been obtained to reduce the risk of material misstatement in the financial statements to an acceptably low level. In arriving at an audit opinion, the auditor must apply professional skepticism and consider all relevant audit evidence, regardless of whether it appears to corroborate or contradict management's assertions in the financial statements. Sufficiency is the measure of the quantity of the audit evidence. Appropriateness is the measure of the quality of audit evidence.

26. The quantity of audit evidence needed is affected by identification and assessment of the risks of material 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.

27. An auditor is required to plan and perform an audit with an attitude of professional skepticism, recognizing that circumstances may exist that may 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.

28. 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.

(III) The Audits

29. While there was no requirement under Ontario securities law for the Four Funds to obtain audited financial statements, BFI chose to retain KPMG to act as the independent auditor for the Four Funds for the fiscal years ended December 31, 2019 and December 31, 2020 (the **2019 Audits** and the **2020 Audits**, respectively; and the **Audits**, collectively). The Audits were intended to build trust with actual and potential investors, to attract and retain investment, and give Unitholders the confidence to reasonably assume they had a true and fair view of the Four Funds' financial position.

30. KPMG is an audit, tax and advisory firm incorporated under the laws of Ontario. It has offices in Ontario and throughout Canada. KPMG is known as one of the largest four accounting

firms in Canada. KPMG is a member firm of KPMG International, a global organization known as one of the largest four accounting firms in the world.

31. KPMG was paid approximately \$400,000 for its work on the eight Audits, which was recorded as an expense to the Four Funds.

32. The 2019 and 2020 Audits were led by KPMG's audit and assurance division (**KPMG Audit**). KPMG Audit sought assistance and support from KPMG's valuation services division (**KPMG Valuation**) and from KPMG's financial risk management division (**KPMG FRM**). At all times, KPMG Audit was ultimately responsible for the Audits of the Four Funds.

33. The objective of the Audits was for KPMG to obtain a reasonable level of assurance about whether each of the financial statements as a whole was free from material misstatement, whether due to fraud or error. In conducting the Audits, KPMG applied an overall materiality threshold of 3% of NAV (**Materiality Threshold**). This meant that if KPMG discovered that the financial statements for any of the Four Funds were misstated by more than 3% of a particular fund's NAV, then KPMG's own assessment was that those misstatements could reasonably be expected to influence a reasonable user's decision-making with respect to that fund.

34. At the outset of the Audits, KPMG was required by GAAS to identify risks of material misstatement and determine whether any of the identified risks were significant.

35. KPMG identified a significant audit risk that BFI's ECL provisions may be understated, resulting in an overstatement of the portion of the Loan Portfolio allocated to the Four Funds, and a corresponding overstatement of the NAV of the Four Funds. This significant risk included the risk that the ECL provisions could be understated through fraud. The calculation of ECL involved BFI's judgments and assumptions and provided BFI Management an opportunity to inflate the NAV of the Four Funds. BFI was compensated through management and incentive fees, both derived from NAV, which created an incentive to inflate the NAV of the Four Funds.

36. KPMG was required to plan and conduct the Audits to obtain sufficient appropriate audit evidence to address these identified risks of material misstatement, through designing and conducting appropriate audit work. This includes ensuring that the nature, timing and extent of audit procedures were sufficient to gain the level of assurance required by an audit opinion. KPMG failed to do so.

37. KPMG was also required to revisit its overall strategy and plan for the Audits in the event identified misstatements and the circumstances of their occurrence indicated that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material. KPMG failed to do so.

38. Because of KPMG's audit failures, particularized below, KPMG failed to obtain reasonable assurance that the financial statements of the Four Funds were free from material misstatement.

(IV) The 2019 Audits

39. Throughout the 2019 Audits, KPMG failed to collect sufficient and appropriate audit evidence over the most critical aspect of the financial statements – the valuation of loans.

KPMG's Review of the ECL Model was Inadequate

40. KPMG relied on the ECL Model as fundamentally sound despite evidence to the contrary.

41. Throughout the Audits, KPMG repeatedly uncovered evidence that BFI's ECL Model did not reliably estimate appropriate and accurate expected credit losses for loans in the Loan Portfolio. Nevertheless, KPMG failed to collect sufficient and appropriate audit evidence to assess the key data elements and assumptions included in the ECL Model.

42. To test the ECL Model, KPMG Audit engaged a team from KPMG FRM to, among other things, review the theoretical soundness of BFI's ECL Model for compliance with the financial asset impairment requirements of International Financial Reporting Standards. KPMG FRM's work did not test the essential question of whether the ECL Model was appropriately tailored to the credit risks of each loan. KPMG FRM did not audit, evaluate or consider any loan in the Loan Portfolio in its review of the ECL Model.

43. KPMG failed to identify that the ECL Model was incapable of appropriately valuing loans in the Loan Portfolio, particularly those that were in financial distress.

44. KPMG Audit failed to evaluate whether KPMG FRM's findings were consistent with other audit evidence gathered and failed to assess whether KPMG FRM's work was sufficient and appropriate for audit purposes.

45. KPMG did not ask fundamental questions such as whether the LGD and PD rates were appropriate for any particular loan given the characteristics of the borrower, whether BFI's

subjective factor was appropriate for any particular loan, whether the collateral supporting the loan existed and was valued appropriately, and whether the overall ECL provision was sufficient to cover the risks of default of the borrower.

KPMG's Response to Testing of High-Risk Loans was Flawed

46. KPMG Audit selected loans and engaged a team from KPMG Valuation to assess the recoverability of those loans. The selection consisted of four loans that KPMG Audit considered complex and high-risk from a valuation perspective, which included loans due from borrowers that were bankrupt or facing liquidation (the **High-Risk Loans**). Those four loans represented 17.5% of the collective NAV of the Four Funds at December 31, 2019.

47. KPMG uncovered problems with BFI's calculations and methodologies for valuing all four High-Risk Loans. The findings of KPMG were as follows.

- (a) Two of the High-Risk Loans were found to have been improperly recorded by BFI as Stage 1 loans (loans performing without indicators of a significant increase in credit risk) when they should have been recorded as Stage 2 loans (loans performing with indicators of a significant increase in credit risk).
- (b) The other two High-Risk Loans were found to have been improperly recorded by BFI as Stage 2 loans (loans performing with indicators of a significant increase in credit risk) when they should have been recorded as Stage 3 loans (loans which are impaired).
- (c) One of the High-Risk Loans that KPMG found to be a Stage 3 loan was a loan owing from **Borrower A (Loan A)**. BFI recorded the value of Loan A at approximately \$137.8 million (net of an ECL provision of only approximately \$2.6 million, or less than 2%) in the Loan Portfolio. BFI's own loan memo for Borrower A estimated Borrower A's enterprise value at \$132.5 million, less than BFI's value of Loan A. KPMG Valuation concluded that Loan A was impaired in the range of approximately \$29 million to \$43 million.

48. KPMG's findings should have caused KPMG to identify that the ECL for the High-Risk Loans should be increased, and the value assigned to the impaired High-Risk Loans should be lowered. These findings ought to have put KPMG on notice that the ECL Model was not reliable

in estimating the ECL for the Loan Portfolio. BFI had calculated an ECL provision for the entire Loan Portfolio of \$17.5 million, and KPMG's own valuations team had concluded that one single loan in the Loan Portfolio (representing approximately 9.4% of the value of the Loan Portfolio) should be impaired by at least \$29 million.

49. Nevertheless, KPMG Audit declined to engage KPMG Valuation for assessment of any further loans for the 2019 Audit and continued to rely uncritically on BFI's ECL Model.

50. BFI Management refused to change the staging of any of the four High-Risk Loans, and refused to record any impairment on any of the four High-Risk Loans. The NAV for the Four Funds was not reduced.

51. KPMG recorded the findings of KPMG Valuation as "uncorrected audit misstatements".

52. KPMG concluded that the tally of uncorrected audit misstatements arising from the High-Risk Loans, together with other uncorrected audit misstatements identified, were below the 3% Materiality Threshold KPMG had established for each of the Four Funds, and that they could represent to Unitholders that the financial statements for each fund as a whole were free from material misstatement. KPMG's conclusion was rooted in audit failures, where additional audit work should have been performed to comply with GAAS.

- (a) For the two High-Risk Loans where KPMG disagreed with BFI's staging only (and did not assign a specific impairment range), KPMG failed to assess how a change in staging would impact the ECL for those loans. KPMG assumed, without evidence or documentation, that a change in staging would not increase the ECL. Had KPMG assessed a change in ECL associated with the change in staging, it would have increased the tally of uncorrected misstatements found by KPMG in the Four Funds' financial statements.
- (b) KPMG failed to sufficiently investigate the discrepancy between the findings of KPMG Valuation and BFI's ECL calculations, which had implications for the reliability and accuracy of BFI's ECL Model as a whole.
- (c) KPMG ignored evidence that BFI's loan valuation approach was simplistic, superficial, aggressive and internally inconsistent. For example, for Loan A, KPMG failed to investigate the discrepancy between BFI's determination of the value of

Loan A using the ECL Model and BFI's own calculations of Borrower A's enterprise value, which was less than the value of Loan A.

- (d) In all the circumstances, BFI Management's refusal to record any impairment on Loan A should have led KPMG to heighten its level of professional skepticism and question the potential bias of BFI Management, including the reliability of BFI's ECL determinations of value for the untested loans within the Loan Portfolio.
- (e) KPMG assumed without additional testing that the errors in staging and/or the errors in valuation identified by KPMG Valuation were isolated to the four High-Risk Loans examined by KPMG Valuation.
- (f) KPMG failed to document any consideration of whether the errors in staging and/or the errors in valuation were isolated occurrences, indicated a risk of errors in relation to the wider Loan Portfolio, or impacted the overall audit strategy and audit plan.
- (g) KPMG did not lower or assess its Materiality Threshold, which could have led to further testing and additional procedures. There is no evidence that KPMG even considered lowering or otherwise assessing its Materiality Threshold.
- (h) Had KPMG expanded its testing and/or lowered its Materiality Thresholds, it would likely have discovered additional misstatements in the financial statements of the Four Funds, particularly in relation to the valuation of loans due from financially distressed borrowers as described below. The accumulation of all misstatements would likely have exceeded the Materiality Thresholds or otherwise been material to Unitholders.

KPMG's Testing of Material Loans was Inadequate

53. KPMG selected a second set of loans to be audited by KPMG Audit (the **Material Loans**). The Material Loans were not assessed by KPMG to be complex, high-risk loans, and as a result, the testing performed on the Material Loans was less rigorous than the valuation work performed by KPMG Valuation on the High-Risk Loans.

54. The Material Loans represented up to approximately 42% of the collective NAV of the Four Funds for the 2019 Audits. Material Loans were defined by KPMG as loans greater than performance materiality that had been outstanding for longer than three months.²

55. For Material Loans, KPMG failed to conduct appropriate and adequate testing for audit purposes and failed to adequately respond to evidence that certain borrowers were financially distressed. KPMG Audit did not critically or adequately assess whether the ECL provision, including BFI's subjective data inputs, was appropriate for any of the Material Loans given the financial condition of the borrower.

56. KPMG Audit's work on Material Loans involved performing financial statement ratio analysis using, at times, unaudited and outdated financial statements of the borrowers. Even this limited testing conducted by KPMG should have caused KPMG to conduct further audit work because it revealed the existence of two additional financially distressed borrowers.

57. The first financially-distressed borrower was **Borrower B**.

- (a) Borrower B is a First Nation or "Band" governed by the *Indian Act*, RSC 1985, c.I-5.
- (b) At December 31, 2019, loans issued to Borrower B (**Loan B**) had a total balance in the Loan Portfolio of approximately \$118.6 million.
- (c) At December 31, 2019, Loan B was syndicated across the Four Funds, with a balance that was above the Materiality Threshold for three of the Four Funds.
- (d) KPMG's working papers indicated that at March 31, 2019, Borrower B had current assets of approximately \$23.6 million, including approximately \$5.8 million in cash. Borrower B did not have sufficient current assets to cover its current liabilities, and KPMG noted that Borrower B "will not be able to pay back its

² Performance materiality is a threshold below overall materiality used in the audit processes of assessing the risks of material misstatement and determining the nature, timing and extent of audit procedures to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds overall financial statement materiality.

current debts (current portion of the long term loan) under the normal course of business.”

- (e) Loan B was originated in 2017 as a PIK loan, with principal and accrued interest due at the maturity date of June 2018. No payments were made by June 2018 and Loan B was extended to June 2019. No payments were made by June 2019 and Loan B was extended to June 2020.
- (f) At December 31, 2019, BFI categorized Loan B as Stage 1 (loan performing without indicators of a significant increase in credit risk). KPMG agreed with this assessment.
- (g) The ECL Model calculated that the probability of default for Borrower B was 2.48%.
- (h) BFI’s ECL provision for Loan B was approximately \$294,000, approximately 0.25% of the total balance of Loan B.

58. In accordance with International Financial Reporting Standards, a loan which is more than 90 days past due should be presumed to be in default unless BFI Management had a reasonable basis to rebut this presumption. A loan in default should be classified as Stage 3 and impairment should be assessed. Impairment of any loan in an amount greater than the ECL would reduce the value of the loan held in the Loan Portfolio and correspondingly reduce the NAV of the Four Funds.

59. KPMG did not identify any indicators of impairment on Loan B. This reflects audit deficiencies, including the following.

- (a) KPMG failed to identify Loan B as a Stage 3 loan which BFI Management continued to renew and extend.
- (b) KPMG did not critically or adequately assess whether BFI Management had reasonably rebutted the presumption that Loan B should be considered a Stage 3 loan and credit-impaired.
- (c) KPMG relied upon the collateral for Loan B without conducting any tests to substantiate the existence or valuation of these assets. KPMG relied upon two trusts

for which Borrower B was the beneficiary to substantiate the valuation of Loan B without conducting any procedures to independently validate the existence or valuation of these trusts or the legal rights of the Four Funds to these trusts in the event of default by Borrower B.

- (d) KPMG did not evaluate, adequately or at all, whether the ECL provision of 0.25% was reasonable and supportable in light of Borrower B's circumstances.

60. The second financially distressed borrower was **Borrower C (Loan C)**.

- (a) Borrower C's unaudited interim financial statements for 2019, included in KPMG's working papers, included a going concern note disclosing that there is "substantial uncertainty on [Borrower C's] ability to continue as a going concern" and "there is significant uncertainty over [Borrower C's] ability to meet its funding requirements as they fall due".
- (b) At December 31, 2019, Loan C had a total loan balance in the Loan Portfolio of approximately \$129.3 million. It was syndicated across the Four Funds, with a balance that was above the Materiality Threshold for three of the Four Funds.
- (c) Loan C was originated in 2017 with a loan balance of approximately \$32.4 million. Borrower C had been in breach of its loan agreements almost from the start, repeatedly failing to make required principal and interest payments. BFI had responded by extending, renewing and increasing its loans to Borrower C.
- (d) The terms of Loan C were amended in 2019 such that Loan C was converted to a PIK loan and periodic principal payments were not required for an agreed upon period of time. Payment of principal and accrued interest were due upon the extended maturity date.
- (e) In 2019, BFI loaned additional funds to Borrower C for general corporate purposes and working capital needs, rather than for specific capital projects.
- (f) Borrower C was a public company. Its shares lost approximately 95% of their value over a one-year period, declining from \$3.90 per share in December 2018 to \$0.1842 per share in December 2019.

- (g) BFI had loaned money to Borrower B for the purpose of purchasing shares in Borrower C, perpetuating the perception that Borrower C was a viable entity.
- (h) The ECL Model calculated Borrower C's probability of default to be 7.87%.
- (i) BFI's ECL provision for Loan C was approximately \$2.5 million, or approximately 1.97% of the total balance of Loan C.

61. KPMG agreed with BFI Management's assessment that there had been a year-over-year significant increase in credit risk for Loan C and it was appropriately reported as a Stage 2 loan (a loan performing with indicators of a significant increase in credit risk). However, KPMG did not critically assess whether the ECL provision for Loan C, including BFI's subjective data inputs, was reasonable and supportable given the current financial condition of Borrower C.

62. KPMG identified that Borrower C had breached its agreement with BFI by not making all required interest payments. However neither KPMG nor BFI identified Loan C as a Stage 3 loan. KPMG did not critically or adequately assess whether BFI Management had reasonably rebutted the presumption that Loan C should be considered a loan in default.

63. KPMG failed to perform further audit procedures when faced with evidence of a likely misstatement regarding Loan B and Loan C. KPMG did not request KPMG Valuation to assess Loan B or Loan C for impairment or propose any impairment in addition to BFI's ECL.

64. Had KPMG performed its audits in accordance with GAAS, it likely would have proposed impairments to Loan B and Loan C. When added to the other uncorrected misstatements found by KPMG, the total impairments would likely have exceeded the Materiality Threshold for the Four Funds or otherwise been material to Unitholders.

KPMG Ignored the Untested Balance

65. Despite the inherent risks of the Loan Portfolio, the problems identified by KPMG Valuation, and the inadequate testing and response by KPMG Audit, KPMG assessed all loans not selected for testing by either KPMG Valuation or KPMG Audit (the **Untested Balance**) as low risk with a low risk of material misstatement.

66. The Untested Balance of the Loan Portfolio was in excess of the Materiality Threshold for each of the Four Funds. For this material Untested Balance, KPMG relied on the essential

soundness of BFI's ECL Model even though none of its inputs had been audited and evidence had already been collected that demonstrated the ECL Model was ineffective.

67. In light of the significant risk identified by KPMG, this was an insufficient level of testing. KPMG did not design or implement appropriate responses to the risk of material misstatement in the Untested Balance.

(V) KPMG's Failure to Evaluate Misstatements and Revise Audit Plan

68. The loan valuation findings, the staging errors, the accumulated misstatements, and the other evidence collected by KPMG regarding financially distressed borrowers, ought to have prompted KPMG to question BFI's ability to appropriately value its most material assets.

69. KPMG failed to make ongoing adjustments to its audit procedures in 2019. KPMG did not:

- (a) reconsider the appropriateness of relying on the ECL Model,
- (b) reassess whether it should assign additional loans to KPMG Valuation for impairment assessment,
- (c) select additional loans for KPMG Audit testing or even assess whether additional loans should be considered for KPMG Audit testing,
- (d) lower or even reassess Materiality Thresholds, or
- (e) document its apparent rationale of why the identified misstatements were isolated and not representative of a potentially pervasive and/or material understatement of ECL provisions and overstatement of the Four Funds' NAVs.

70. The audit deficiencies meant that valuations that were patently overstated at the relevant time were left uncorrected.

- (a) For Loan A, BFI recorded an ECL of only approximately \$2.6 million on a total loan balance of approximately \$140.4 million when KPMG Valuation estimated impairment in the range of \$29 million to \$43 million and Borrower A had declared bankruptcy.

- (b) For Loan B, BFI recorded an ECL of only approximately \$294,000 on a total loan balance of approximately \$118.6 million when Borrower B did not have sufficient current assets to cover its current liabilities, had only approximately \$5.8 million in cash, had not made any payments since Loan B was first originated in 2017, and interest payments were being accrued and added to the principal loan amount (PIKed) by BFI Management.
- (c) For Loan C, BFI recorded an ECL of approximately \$2.5 million on a total loan balance of approximately \$129.3 million when Loan C had been extended multiple times with amended terms such that periodic principal and interest payments were no longer required until the extended maturity date.

71. Had KPMG identified a reasonable impairment adjustment for each of Loan B and Loan C, these adjustments would likely have caused total identified misstatements to exceed the Materiality Thresholds for the Four Funds or been otherwise material to Unitholders.

(VI) The 2020 Audits

KPMG Failed to Perform Required Retrospective Reviews of BFI's Loan Valuations

72. For the 2020 Audits, GAAS required KPMG to conduct a retrospective review of BFI's ECL calculations in the prior year to ensure that planning for the 2020 Audit was appropriate. This involves comparing prior period estimates with actual outcomes to evaluate the effectiveness of BFI Management's estimation process and identify any potential biases. KPMG concluded that prior period amounts involving BFI's judgments and assumptions were not misstated without sufficient analysis to support this conclusion.

73. Throughout the 2020 Audits, KPMG continued to rely on the ECL Model even though:

- (a) KPMG had not evaluated the adequacy of KPMG FRM's work in relation to the ECL Model, including the relevance and reasonableness of KPMG FRM's findings and conclusions and their consistency with the outcome of the work performed by KPMG Valuation;
- (b) KPMG did not test the inputs to the ECL Model for any loan within the Loan Portfolio;

- (c) The ECL Model did not adequately account for the unique risk features of the Loan Portfolio;
- (d) The ECL Model allowed for a significant degree of BFI Management subjectivity; and
- (e) Data from KPMG Valuation and KPMG Audit called the reliability of the ECL Model into question.

Failure to Respond to Identified Fraud

74. Gary Ng was a 50% shareholder of BFI and the counterparty to several loans issued by BFI totalling approximately \$113 million as at December 31, 2019 (the **Ng Loans**). The Ng Loans had been extended prior to 2019 on the basis they were collateralized by a \$90 million security portfolio held by a financial institution. The collateral was a fiction (the **Fraud**).

75. KPMG was notified by BFI of the Fraud on or about September 1, 2020, during the planning of the 2020 Audits. KPMG failed to take adequate steps to understand the nature, scope or potential impact of the Fraud and its implications for the 2020 Audits, including its implications for KPMG's ability to rely on BFI Management's representations, the effectiveness of BFI's due diligence controls upon the issuance of new loans, and the risk that other loans may exist with non-existent, fictitious or insufficient collateral.

76. KPMG failed to appropriately test the existence, accuracy, valuation and rights over the collateral of the largest loans in the Loan Portfolio.

77. KPMG failed to document any consideration of whether it was appropriate to undertake additional procedures in relation to loan collateral in response to the Fraud.

Persistent Audit Failures

78. For the 2020 Audits, KPMG followed the same procedures it had used in 2019.

- (a) Again, KPMG sent a population of loans (representing approximately 30% of the NAV of the Four Funds) to be tested by KPMG Valuation.

- (b) Again, KPMG Audit selected only Material Loans for further testing. Again, the Material Loans represented, at most, approximately 44% of the NAV of the Four Funds for the 2020 Audits.
- (c) Again, KPMG failed to design and implement appropriate audit procedures over the valuation of the Untested Balance of the Loan Portfolio syndicated to the Four Funds.
- (d) Again, none of KPMG's testing involved testing the inputs to the ECL Model for any loan within the Loan Portfolio.

79. In conducting the 2020 Audits, KPMG ignored not only the red flags that arose during the 2019 Audits, but new red flags that arose in the course of the 2020 Audits: a write-off of Loan A, and evidence of the worsening credit risk of Loan B and Loan C.

80. As in 2019, if KPMG had identified impairments in relation to Loan B and Loan C by complying with GAAS, the total impairments would likely have exceeded the Materiality Thresholds for the Four Funds or otherwise been material to Unitholders.

Audit Failures Relating to Loan A Write-Off

81. Less than four months after the issuance of the 2019 audited financial statements for the Four Funds, BFI recorded a write-off of approximately \$60 million on Loan A (the **Loan A Write-Off**). This write-off was almost four times greater than BFI's ECL provision for the entire amount of the Loan Portfolio allocated to the Four Funds at December 31, 2019, of approximately \$17.5 million. It was more than twenty times greater than BFI's ECL for Loan A at December 31, 2019, of approximately \$2.6 million.

82. Some write-off of Loan A had been foreseeable at the time of the 2019 Audits, as Borrower A had filed for bankruptcy in February 2020 because it had been unable to service their debt obligations to BFI. The ECL Model should have adequately incorporated forward-looking information. For the 2019 Audit, KPMG Valuation had proposed an impairment range for Loan A of approximately \$29 million to \$43 million. BFI Management had refused to recognize any impairment. When BFI Management changed their mind less than four months after the December 31, 2019 auditor's reports for the Four Funds' financial statements were issued, KPMG should have considered:

- (a) whether the Loan A Write-Off called the reliability of the ECL Model into question, and
- (b) whether, in combination with other factors, the Loan A Write-Off represented an indicator of BFI Management bias.

83. KPMG still continued to rely on the ECL Model in the 2020 Audits. KPMG apparently assumed that the discrepancy between the ECL calculation and the actual Loan A Write-Off was irrelevant to the valuation of the balance of the Loan Portfolio without performing any testing to support that assumption or documenting the reason for its assumption.

Worsening Credit Risk of Loan B to Borrower B

84. Loan B was one of the Material Loans for the 2020 Audits. Borrower B failed to make required principal and interest payments by the extended maturity date of June 2020 and Loan B was further extended to December 2020. Borrower B again failed to make required principal and interest payments by December 2020 and Loan B was once again extended to June 2021. BFI Management renewed Loan B each time to extend the maturity date while also continuing to provide additional advances.

85. At December 31, 2020, BFI categorized Loan B as Stage 2 (a loan performing with indicators of a significant increase in credit risk). KPMG agreed with this assessment.

86. BFI Management did not consider Loan B to be in default. BFI's ECL Model calculated Borrower B's probability of default to be 19.73%. BFI's ECL provision for Loan B continued to be approximately 1.97% of the total Loan B balance.

87. KPMG did not critically or adequately assess whether BFI Management had reasonably rebutted the presumption that Loan B should be considered a Stage 3 loan in default. KPMG did not document any consideration of whether Loan B should be considered a Stage 3 loan in default. KPMG did not recommend any impairment on Loan B or refer Loan B to KPMG Valuation.

Worsening Credit Risk of Loan C to Borrower C

88. Loan C was one of the Material Loans for the 2020 Audits. The data collected by or available to KPMG Audit showed a worsening of Borrower C's financial condition as compared to 2019 and further breaches of the repayments terms of Loan C.

- (a) From December 31, 2019 to December 31, 2020 the total balance of Loan C had increased from \$129.3 million to \$153.6 million, due to PIKed interest and additional advances from BFI. BFI had allowed Borrower C to stop making monthly principal and interest payments. Unpaid interest continued to be accumulated and added to the balance of Loan C and Borrower C's monthly principal payments were uncollected past the loan repayment timeline agreed upon with BFI.
- (b) In 2019, Borrower C reported a write-off of all of its goodwill balance (approximately \$154.7 million) and approximately 80% of its intangible assets (approximately \$46.4 million). Overall, Borrower C wrote down approximately half of its total assets.
- (c) KPMG's working papers indicated that, as of September 30, 2020, Borrower C had only current assets of approximately \$17.4 million, including approximately \$4.2 million in cash.
- (d) KPMG's financial statement ratio analysis indicated that Borrower C did "not have sufficient liquid assets available to cover its short-term liabilities" and was "not in a solvent position".
- (e) The unaudited interim 2020 financial statements for Borrower C, included in KPMG's working papers, indicated that the balance of Loan C exceeded the total assets of Borrower C. These financial statements included the same "going concern" note as in 2019, indicating that the financial conditions "create a material uncertainty which may cast a significant doubt in [Borrower C's] ability to continue as a going concern." These financial statements also identified that Borrower C was in "breach of its financial covenants" in relation to Loan C.
- (f) During 2020, the share price of Borrower C dropped approximately 79%, from \$0.1842 per share in December 2019 to \$0.038 in December 2020.

89. BFI Management did not consider Loan C to be in default. In fact, BFI concluded that Company C had increased in value from 2019 to 2020.

90. BFI's ECL Model calculated Borrower C's probability of default to be 7.84%, less than it was at December 31, 2019. BFI's ECL provision for Loan C continued to be approximately 1.96% of the total Loan C balance.

91. KPMG did not identify Loan C as in default. KPMG did not adequately assess whether BFI Management had a reasonable basis to rebut the presumption that Loan C should be considered a Stage 3 loan in default.

92. KPMG recommended that Loan C be considered a Stage 2 loan, with a significant increase in credit risk. BFI declined to accept KPMG's recommendation.

93. KPMG did not recommend any impairment or refer Loan C to KPMG Valuation.

94. KPMG did not document any consideration of whether the ECL provisions for Loan B or Loan C were appropriate given the financial circumstances of each borrower at the relevant time.

(VII) KPMG's Failures to Comply with Generally Accepted Auditing Standards

95. For each of the eight audits, KPMG issued an independent auditor's report directed to the Unitholders of each fund, stating KPMG's opinion that the financial statements presented fairly, in all material respects, the financial position of the respective fund. In each of the eight auditor's reports, KPMG represented to Unitholders that KPMG had conducted its audits in accordance with Canadian GAAS. These representations were false.

96. The conduct described above violated GAAS. For each of the 2019 and 2020 Audits, KPMG failed to comply with the following CAS:

(a) CAS 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*, by:

- (i) failing to plan and perform each of the 2019 and 2020 Audits with professional skepticism;
- (ii) failing to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level;
- (iii) failing to document their consideration of the nature and extent of adjusted and unadjusted misstatements identified through the Audits;

- (iv) failing to comply with all CAS relevant to the Audits;
- (b) CAS 320, *Materiality in Planning and Performing an Audit*, by failing to consider the misstatements identified in its assessment of materiality thresholds, which could have resulted in materiality thresholds being revised downwards and/or to additional procedures being performed;
- (c) CAS 330, *The Auditor's Responses to Assessed Risks*, by failing to design and perform audit procedures to obtain sufficient appropriate audit evidence in response to the risk of material misstatement in relation to the valuation of loans;
- (d) CAS 450, *Evaluation of Misstatements Identified During the Audit*, by failing in its evaluation of misstatements identified and indicators of BFI Management's bias;
- (e) CAS 500, *Audit Evidence*, by failing to design and perform audit procedures that were appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence, and failing to document its consideration of various aspects of the Audits, including but not limited to its evaluation of the relevance and reliability of information to be used as audit evidence in assessing BFI's loan valuations;
- (f) CAS 530, *Audit Sampling*, by failing to document its consideration of whether misstatements identified were isolated and evaluate their possible impact on the Audits;
- (g) CAS 540, *Auditing Accounting Estimates and Related Disclosures*, by failing to conduct effective retrospective review procedures over BFI's calculation of ECLs; and
- (h) CAS 620, *Using the Work of an Auditor's Expert*, by failing to identify the inadequacies in KPMG FRM's work over the ECL Model for auditing purposes.

97. For the 2020 Audits, KPMG also failed to comply with the following CAS:

- (a) CAS 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, in failing to appropriately evaluate the implications of an identified fraud; and

- (b) CAS 560, *Subsequent Events*, in failing to consider whether the 2019 financial statements of the Four Funds required restating following identification of the fraud after the 2019 Audit opinions were issued.

(VIII) Subsequent Events

98. On April 30, 2021, one month after KPMG's auditor's reports for 2020 were issued, BFI and all its assets, including the Four Funds, were put into receivership by the Ontario Superior Court of Justice. This was initiated by an application of the Commission because of concerns that BFI management was in conflict with certain loan counterparties and had misappropriated investor funds. PricewaterhouseCoopers Inc. was appointed receiver and manager of BFI (the **Receiver**).

99. At the time of the receivership, the audited financial statements of all of BFI's funds (including the Four Funds) represented that its total assets under management was approximately \$2.09 billion. The Receiver has claimed that unitholders will lose approximately \$1.4 billion, in part because of significant deficiencies in the value of the Four Funds' loan portfolio, including insufficient and falsified collateral.

100. On or about October 29, 2021, KPMG notified the Receiver that it was withdrawing the auditor's reports on the financial statements of the Four Funds for the years ended December 31, 2019 and December 31, 2020.

101. As of March 2025, the Receiver had collected approximately \$317 million from the liquidation of BFI's assets under management. This is approximately 15% of the total \$2.09 billion in assets under management represented by BFI.

102. Specifically, as of March 2025, the Receiver had collected approximately \$863,000 for Loan A (0.93% of BFI's December 31, 2020 book value for Loan A), approximately \$953,000 for Loan B (0.71% of BFI's December 31, 2020 book value for Loan B) and approximately \$11.3 million for Loan C (7.36% of BFI's December 31, 2020 book value for Loan C).

C. BREACHES

The Commission alleges the following breaches of Ontario securities law and/or conduct contrary to the public interest.

103. An auditor must not represent compliance with GAAS in an auditor's report unless the auditor has complied with the requirements of all individual Canadian auditing standards relevant to an audit. By falsely stating in each of the eight auditor's reports that it had conducted the audit in accordance with GAAS, KPMG breached subsection 126.2(1) of the *Securities Act* eight times.

104. These were statements that KPMG knew or reasonably ought to have known, in a material respect and at the time and in light of the circumstances under which they were made, were misleading or untrue or did not state a fact that was required to be stated or that was necessary to make the statements not misleading. The Audits did not comply with GAAS. KPMG's statements to the contrary would reasonably be expected to have a significant effect on the market price or value of units of the Four Funds.

105. Had Unitholders known that the NAV of the Four Funds was materially overvalued, the price or value of the Four Funds would reasonably be expected to have been significantly lower.

106. Had Unitholders known the Audits were not conducted in accordance with GAAS, the price or value of the Four Funds would reasonably be expected to have been significantly lower. The existence of audited financial statements that complied with GAAS would be considered important to a reasonable investor in determining whether to purchase or continue to hold units of the Four Funds. Because KPMG's Audits did not comply with GAAS, Unitholders were deprived of the benefits of audits that complied with GAAS, significantly affecting the value of their investment.

107. Further and in any event, the conduct described above is contrary to the public interest. Because the Four Funds were private investment vehicles, sold in the exempt market without a prospectus, there was less information available as compared to public markets. KPMG's audit opinions were one of the only sources of independent information concerning the financial health of the Four Funds. By representing it had complied with GAAS when it had not, KPMG's conduct offended the need for accurate disclosure of information, which is a fundamental animating principle of securities regulation.

D. ORDERS SOUGHT

The Commission requests that the Tribunal make the following orders against KPMG pursuant to subsection 127(1) and section 127.1 of the *Securities Act*:

- (a) that KPMG be reprimanded, pursuant to paragraph 6 of subsection 127(1);

- (b) that KPMG pay an administrative penalty of not more than \$5 million for each failure to comply with Ontario securities law, pursuant to paragraph 9 of subsection 127(1), totalling not more than \$40 million for all eight false and misleading auditor's reports issued;
- (c) that KPMG disgorge any amounts obtained as a result of non-compliance with Ontario securities laws pursuant to paragraph 10 of subsection 127(1); and
- (d) that KPMG pay costs of the investigation and the hearing, pursuant to section 127.1.

DATED at Toronto, Ontario, this 31st day of March, 2026.

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