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MFDA Bulletin

Compliance

For Distribution to Relevant Parties within your Firm

Common Errors in Financial Filings and Frequently Asked Questions

General Information

Pursuant to MFDA Rule 3.5.1(a), each Member shall file monthly with the MFDA within 20 business days of the month's end a copy of a financial report of the Member as at the end of each fiscal month. MFDA Member Regulation Notice MR-0018 allows for a transition period to the monthly filing requirement. During the transition period, unless specifically requested by MFDA staff to file more frequent financial information, Members are required to file quarterly financial information based on each Member's fiscal quarter ends. The financial information is to be presented in the form prescribed by the MFDA, which is the Form 1 - MFDA Financial Questionnaire and Report ("FQR").

In addition, MFDA Rule 3.5.1(b) requires the Member to file annually with the MFDA audited financial information within 90 days of the of the period end date. The audited financial information includes both financial statements prepared in accordance with Generally Accepted Accounting Principles ("GAAP"), and in the prescribed FQR format.

This Bulletin is intended to assist Members and their auditors in the completion of the FQR.

Most Common Errors

(Note: References below relate to the FQR Version dated June 13, 2003)

Currently all Members are required to complete and submit an FQR reflecting the operations of the Member. MFDA staff have noted the following errors that commonly appear on Member FQR filings:

General

- The Statements and Schedules do not add correctly.
- Balances reported and calculated on certain Statements or Schedules are not carried forward correctly or consistently to relevant Statements or Schedules. (e.g. the ending retained earnings balance reported on Statement E line C-3, should equal the retained earnings reported on Statement A line 39).
- Balances are not properly rounded to the nearest dollar.

Certificate of Partners or Directors

- The Certificate of Partners or Directors is not signed by two qualifying individuals
- The Certificate of Partners or Directors is not correctly completed with only “Yes” or “No” responses. Often Members document “N/A” next to question #1 which is not acceptable.

Statement A

- Commissions receivable from mutual fund companies are not accrued and reported on line 4.
- Details of balances reported are not provided, although specifically requested (i.e. line 18)
- Receivables from salespersons are netted against commissions payable to salespersons. This is only permitted if the salesperson to which the netted receivable / payable relates is the same. The balances may not be netted on a gross basis.
- No balance is reported on line 26, as variable compensation payable. Generally there will be a commission amount owing to salespersons that has not yet been paid and therefore, should be reported on this line.
- Line 20 and 41 do not equal. These balances should always be the same.
- Accounts payable / accrued liabilities are not considered or reported on line 28. Generally there will be expenses incurred but not yet paid and therefore should be reported on this line (e.g. audit fee accrual)
- Prepaid expenses and fixed assets are not amortized / depreciated each period. A portion of prepaid expenses should be expensed each period as time passes. Depreciation on fixed assets must also be considered and expensed on Statement D.
- Current portion of long-term liabilities and capital leases are not properly determined and reported.

Statement B

- Minimum capital reported on line 4 is not the amount required as per MFDA Member Regulation Notice MR-0001.
- Members do not consider or report contingent liabilities on line 7.
- Members do not consider or report unresolved differences in nominee-name assets or in the trust account.
- The FIB deductible may not reflect the clause in the policy with the highest deductible, as required.

Statement C

- Net income for the quarter is reported on line C1. The absolute value of only net losses for the quarter ended should be reported on this line.
- Year-to-date or month-to-date net losses are reported on line C1. Net losses for the three months ended should be reported.

Statement D

- Lines 1 and 2 are not completed, as required
- Balances reported do not coincide with the reporting period (i.e. month to date or quarter to date figures)
- Assets under administration reported include accounts of clients resident in Quebec. The market value of mutual fund assets held for Quebec clients should be excluded from this balance.
- Discretionary bonuses are included in line 18. All discretionary bonus expenses must be reported on line 20.
- A provision for taxes is not accrued and reported on line 21(a). Income taxes must be considered and provided for on the FQR.

Statement E

- Details of the share capital attributes are not disclosed in section B as required.
- Retractable preference shares are included as capital. This classification is only appropriate if an Undertaking in accordance with Member Regulation Notice MR-0013 has been signed and submitted to the MFDA.
- Line C1 does not agree with the previous FQR filing, as required.

Statement F

- Details of the lender, debt and amount increases / decreases for the period are not disclosed.

Schedule 1

- Incorrect margin rates are being used for marketable securities. The Notes and Instructions to Schedule 1 document the required rates to be used. It should be noted that only money market mutual funds that satisfy the definition as such in NI 81-102 can be margined at the 5% rate. All other mutual funds are required to be margined at 50%.

Schedule 3

- Line A1 does not agree with the previous FQR filing, as required.
- Balance reported on Statement D line 21(a) does not agree to Schedule 3 line 5. These amounts should agree.
- Deferred tax assets and deferred tax credits are netted together and reported as one balance on Statement A line 18 or 25 and/or 32. Deferred tax assets and liabilities should not be netted together, but should be reported gross on Schedule 3 and Statement A.

Schedule 4

- Line A3, Excess / (Deficiency) in coverage, is not calculated correctly. This amount should be the difference between line A2, Coverage maintained per FIB, and the greatest amount calculated under line A1.
- The amount reported on line 4 as the deductible is not the greatest amount under each clause. Some FIB policies have a higher deductible for certain clauses (e.g. agent riders). This is the deductible amount that must be reported on line 4.
- Members are not completely reporting details under Part C and D, as required. If there are no losses or claims, the Member must report “Nil” under Part D.
- The insurance broker is named in Part C rather than the insurance company.

Audit Requirements

Part I Auditors Report

- Auditors are providing opinions on prior year balances. This is not required if the dealer was not a MFDA Member as at its previous fiscal year-end.

Report on Compliance for Segregation of Cash and Securities

- Auditors have reported “not applicable” in the exceptions section of the Report for level 4 dealers. If no exceptions were noted, the appropriate response would be “Nil”.

FQR Completion Tips

In order to minimize the number of errors reported on the FQR filing, the Member may consider the following:

- Prepare the FQR in the following Statement / Schedule order:
 - Statement D to Statement F
 - Schedule 1 to Schedule 4
 - Statement A to Statement C

- Use the cross-references notations on the Statements and Schedules to ensure the balances that are carried forward to/from other Statements / Schedules are consistently reported. For example, total long marketable securities reported on Schedule 1, line 6, should be carried forward to Statement A, line 3.
- Re-add each Statement and Schedule before submitting the FQR.
- Review the FQR filing to ensure that details are provided for all lines that state “attach details”.
- Compare balances reported on the FQR to be filed with the respective balances reported on the previous FQR submitted. If there are significant differences, consider whether you are aware of why these differences have occurred.
- Use the General Notes and Instructions, and the Notes and Instructions to each Statement and Schedule when determining how a balance should be reported on the FQR.
- Ensure an original copy of the FQR is signed and submitted to the MFDA as required. (A copy of the audited GAAP financial statements are also required to be submitted within 90 days of the Member’s fiscal year end.)

Frequently Asked Questions

Q: Do I need to complete and submit every page in the FQR each time I file the Member’s financial information with the MFDA?

A: Yes, every Statement and Schedule should be completed every time an FQR is submitted to the MFDA. The FQR cover page indicates those additional reports that need only be completed and submitted at the audit date. (Note: Member Regulation Notice MR-0005 states that only Statements A to D and Schedule 1 are required to be filed every time an FQR is submitted. As at March 1, 2004, the MFDA will be requiring that all Statements and Schedules be submitted.)

Q: What balances should be reported as the opening balances on Statement E and F, and Schedule 3? Should the balances be the closing balances as per the Member’s last fiscal year end or be the closing balances reported on the last FQR submitted to the MFDA?

A: Unless otherwise instructed to do so by MFDA staff, the opening balances on the above Statements and Schedules should be the closing balance reported on the last FQR submitted to the MFDA. For annual audited FQR’s, the opening balance should be that reported on the last audited financial statements / FQR, as at the Member’s fiscal year end.

Q: For what period should be reported in Statement D? Should this be monthly, quarterly, or year to date figures?

A: If the Member is required to submit monthly FQRs, then Statement D should reflect the revenue and expenses for that 1 month period. If the Member files quarterly information, then Statement D should reflect revenues and expenses for the 3 month period ended. All annual audited FQRs should report revenues and expenses for the 12 months ended as at the Member's fiscal year end.

Q: Why are only some of the Member's assets considered to be "allowable" for the purposes of determining Risk Adjusted Capital ("RAC") and others are not?

A: To allow for greater client protection, regulatory bodies have taken a more stringent approach in determining capital of a dealer compared to what would normally be determined as financial statement capital under GAAP. This approach under MFDA Rules considers both the liquidity and counterparty risk in assessing whether an asset should be "allowable" or "non-allowable". Hence, only assets that are liquid in nature, and are collectable from an Acceptable Entity (as defined in the "General Notes and Definitions" in the FQR) can be classified as "allowable" in the determination of Risk Adjusted Capital of a MFDA Member.

Q: In simple terms, what is a "Regulated Entity"?

A: As a first point of reference, Members should refer to the General Notes and Definitions that form part of the FQR if uncertain as to how to complete the FQR. Regulated Entities are considered Acceptable Entities and are defined in the General Notes and Definitions as companies that are covered by the Canadian Investor Protection Fund or Members of recognized exchanges and associations. Generally, only those entities where, in the event of insolvency, client assets of the company are protected by a third party fund are considered regulated. In addition to a protection fund, regulated entities are generally those companies that must maintain a required level of capital, and are monitored and examined on a regular basis for capital adequacy.

Q: When do I have to submit to the MFDA the Member's financial information?

A: MFDA Rule 3.5.1(a) requires that each Member file a complete FQR with the MFDA within 20 business days of each fiscal month-end, including the fiscal year-end month. (Note: MFDA Member Regulation Notice MR-0018 allows for a transition period for the monthly financial filing requirement. Under this Notice, Members may file quarterly financial information with the MFDA, unless specifically requested by MFDA staff to file more frequently.) In addition, Rule 3.5.1(b) requires that audited financial information be submitted within 90 days of the Member's period end that is reported on.

Members should also be aware of MFDA Rule 3.5.5(b) which states that Members will be liable to the MFDA for fees imposed as a result of a late filing of any financial information. MFDA Member Regulation Notice MR-0021, Late Filing Fees, provides the specific details of the late fees that will be imposed, effective December 1, 2003.

Q: Can I send in the Member's audited FQR to the MFDA or is my auditor required to do that?

A: MFDA Rule 3.5.1(b) requires that the Member's auditor file with the MFDA the audited financial information required under the Rule.

Q: A number of the questions on the Certificate of Partners or Directors are not relevant to the operations of my firm. How should I answer these questions?

A: All questions on the Certificate of Partners or Directors should be responded to as "Yes" or "No", if relevant to the Member's Dealer Level (i.e. for levels 3 and 4 dealers, all questions are relevant). Responding with "N/A" is only acceptable for level 1 and 2 dealers for questions #2, 3 and 6. It should be noted that question #1 must be answered as "Yes" or "No" for all Members. As per the Notes and Instructions to this Certificate, details must be provided for all "No" responses.

Q: I see on Statement B there is a requirement to reduce RAC by 10% of all contingent liabilities. What is considered a contingent liability for this purpose?

A: Under Canadian GAAP, companies are required to accrue in the financial statements a contingent loss if (i) it is likely a loss will arise upon the occurrence of a future event and; (ii) the amount of the loss can be reasonably estimated. If a Member has accrued for this type of loss in the FQR, then an additional 10% capital reduction on Statement B is not required. Consideration should be made for pending lawsuits against the Member. If the potential loss can be reasonably quantified and the likelihood of loss is uncertain, then under GAAP it would not be accrued. In addition, there would not be a 10% capital deduction for this contingency on Statement B line 7. However, in order to assess the status of a pending legal action, a Member may be requested by MFDA staff to provide evidence of a current legal opinion on the matter.

As well, there may be instances where a Member may be required to accrue for a potential loss even where there is no client complaint or lawsuit filed if the loss is likely and reasonably quantified.

An example of a contingent loss is a guarantee signed by the Member on behalf of another company. If that company defaults on its obligation, the Member may then become responsible for the obligation, as evidenced in the guarantee. Hence, a reduction to capital is considered necessary to conservatively account for this possibility.

Q: Assuming the Member is a level 2 or 3 dealer, and there is only one salesperson and one licensed assistant, how much financial institution bond (“FIB”) coverage is the firm required to have? What if there is only one salesperson and one Officer of the company?

A: As a level 2 or 3 dealer, the minimum FIB coverage is \$50,000 per Approved Person. In both of the above cases, there are two individuals who meet the definition of an Approved Person. Hence, the Member would be required to maintain a single loss limit of \$100,000 in FIB coverage with a double aggregate of \$200,000 or a reinstatement provision in the policy.

Q: The Member collects fees from the branch locations which are incorporated companies. Where do I report this receivable on the FQR?

A: Although the branches are separate legal entities, they are not considered Regulated Entities. Therefore, any amounts receivable from the branches should be reported as a non-allowable asset on Statement A, line 18.

Q: Can the commissions payable to the salespersons be netted against the receivables from the branch locations for reporting purposes on the FQR?

A: Payables and receivables may be netted together for reporting purposes only if they are owed to or receivable from the same organization or individual. For example, a receivable from a salesperson may only be netted against the commission payable to the same salesperson. The receivable and payable balances may not be netted on a gross basis.

Q: Do I have to report commissions owed to the Member but not yet received on the FQR?

A: The FQR must be prepared in accordance with GAAP, which requires the accrual method of accounting be used. This means that all commissions, including trailer commissions, must be reported on the FQR once the following conditions have been met (i) they have been earned by the Member (ii) the amount is likely collectible and (iii) the amount can be reasonably estimated.

Q: When do I have to report commissions owed to salespersons on the FQR? Once the Member collects the commission revenue from the mutual fund company, or sometime before this time?

A: The FQR must be prepared in accordance with Canadian GAAP, which requires the accrual method of accounting be used. This means that as soon as a liability has been incurred, the payable must be reported on the FQR. If the Member has commissions receivable from the mutual fund company the corresponding payable to the salespersons must also be accrued and reported on the FQR.

Q: Do I have to accrue for discretionary bonuses on the FQR at the end of each period? I never know how much the bonus is going to be until the end of the year as my accountant generally determines how much it will be.

A: Discretionary bonuses do not have to be reported on the FQR until they have been determined. However, an income tax provision must be calculated at the applicable tax rate on the net income reported before bonus.

Q: How do I know what the minimum capital amount should be on Statement B line 4? It always seems to be changing.

A: MFDA Rule 3.1.1 documents what the minimum capital requirements are for each Member level. This information is also found in the Notes and Instructions to Statement B on the FQR. In addition, it should be noted that MFDA Member Regulation Notice MR-0001 provides for a transition period for Members to comply with the minimum capital requirements under Rule 3.1.1. Effective March 1, 2004, the minimum requirements of Rule 3.1.1 will apply.

Q: In simple terms, what is an “unresolved difference”?

A: Unresolved differences are differences in nominee-name client assets (e.g. cash in trust, mutual fund positions) and/or Member assets (e.g. operating bank account, investments) according to the Member’s records when compared against a third party custodian’s records (e.g. bank statement or mutual fund statement). Differences are only considered “unresolved” if the Member’s books show more assets are held than what the custodian’s records report. In addition, a difference is considered “unresolved”, if a journal entry has not been made to resolve the difference by the filing due date of the FQR (e.g. within 20 business days for the unaudited FQR filing and within 90 days for the audited FQR filing). If a journal entry is made and the entry results in the difference being booked to profit or loss in the period subsequent to the FQR date, appropriate margin is still required.

Margin required on an unresolved difference in a client security held in nominee name of the Member would be equal to the market value of the client position that is short, plus the applicable margin rate for that security. Margin required on an unresolved difference in the Member’s investments would be equal to the market value of the investment position that is short.

Q: If the Member has a bank loan which is secured by assets of the company, can I still report those assets as “allowable” on the FQR?

A: All assets that are used as collateral against a loan cannot be considered “allowable” assets as they are not available for disposition to all clients and creditors in the event of the dealer’s insolvency. Hence, all assets normally considered allowable (e.g. cash, receivables from mutual fund) may be classified as allowable up to a maximum amount of the current portion of the bank

loan which would be normally reported on Statement A lines 21 or 30. All other assets should be reported as non-allowable.

Q: The Member has a “Due to shareholder” balance. The amount has no set terms of repayment and the Member does not plan to repay the loan within the next year. How should this be reported on the FQR?

A: Under the circumstances described above, repayment of the due to shareholder balance is at the discretion of the Member which is likely controlled or significantly influenced by the shareholder. For this reason, the due to shareholder balance must be reported as a current liability on Statement A line 30. For FQR reporting purposes, “no set terms of repayment” terms are analogous to “repayment on demand” terms.

Q: Explain the profitability test on Statement C.

A: The profitability test is a test designed to assess adequacy of a Member’s Risk Adjusted Capital (“RAC”) on a forward- looking basis. The test compares the absolute value of the net loss incurred by the Member in the past three months (e.g. Statement D line 19 of the June 13, 2003 Form 1 version)), if applicable, to RAC. If RAC is less than the absolute value of the 3 month net loss, then the test triggers a “yes” response. This indicates that if the Member continues to operate with similar profitability results over the next 3 months, the Member may be capital deficient at that time. (It should be noted that effective March 1, 2004, monthly reporting is required by Members. Please note that the Profitability Test will remain unchanged. The Test will continue to compare RAC against the net loss for the most recent 3-month period.)

For audited FQRs, the Profitability Test is also always calculated based on net loss for the most recent 3-month period.

Q: Given the MFDA requires the Member to report its own investments at market value rather than at cost, were do I record the difference to balance the FQR Statements?

A: All realized and unrealized gains relating to the Member’s marketable securities should be reported on Statement D, line 16, Realized/Unrealized (Gain)Loss on Marketable Securities. The difference between cost and market value of the securities will then flow through the retained earnings balance, resulting in a balanced Statement A.

Q: The Member’s share capital includes preference shares that are retractable (i.e. may be redeemed at the discretion of the shareholder). How should these shares be reported on the FQR?

A: *Although retractable preference shares are considered share capital, the retractable feature of the shares makes them have the characteristics of demand debt. Given the shareholder may redeem the preference shares at anytime, the redemption value must be recorded as a current liability on Statement A, line 30. If the Member requires these shares to be treated as share capital for the purposes of calculating RAC, then the shareholder and the Member must sign an Undertaking in the form prescribed in MFDA Member Regulation Notice MR-0013. This Undertaking provides that prior written approval from the MFDA be obtained before the Member can redeem, retract, repurchase or return any capital in respect of the shares.*

Q: *If the Member is short equity positions, is the margin required on Schedule 1 negative?*

A: *No. The applicable margin rate is applied to the absolute market value of the short positions and reported on Schedule 1. The margin calculated is then carried forwarded to Statement B as a reduction to capital.*

Q: *If the dealer was not a member of the MFDA as at its last fiscal year end, does the auditor have to provide an opinion on the prior year's balances in the FQR?*

A: *No.*

Q: *I understand from Member Regulation Notice MR-0018 that effective March 1, 2004, Early Warning requirements will be imposed automatically if any one of the Early Warning Tests fail. Does this mean that the Frequency Test will be based on the Member's financial filings during the past 12 months, or will there be some relief for Members failing the Early Warning Tests during the transition period?*

A. *Members who triggered Early Warning Tests more than 2 times during the rolling 12 month period prior to March 1, 2004, will be required to respond "Yes" to failing the Frequency Test on their monthly FQR. This is required so that an accurate history of the Member's financial filings is maintained by the MFDA. However, MFDA staff recognize that the rationale for providing such a transition period for Early Warning sanctions was to allow Members the opportunity to adjust their financial structure to ensure adequate risk adjusted capital is maintained in the future and to ensure appropriate consideration is given to the firm's liquidity (e.g. the Liquidity Test) and profitability (e.g. Profitability Test). Therefore, until December 1, 2004, Early Warning sanctions will not be automatically imposed on Members failing only the Frequency Test, if the failure related to Early Warning Tests triggered prior to March 1, 2004.*

Q: As a small privately held Member of the MFDA, can the firm submit GAAP financial statements prepared in accordance with the new CICA Handbook Section 1300, Differential Reporting?

A: No. The intent of this Handbook section is to allow for limited reporting for closely held private companies where all the users of the financial statements have sufficient knowledge of the company without relying on the financial statements. The MFDA does not have such knowledge of the Member and therefore, does not permit Members to submit financial statements prepared in accordance with Section 1300.

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