VIEWPOINTS:

Applying IFRSs in the Mining Industry

FLOW-THROUGH SHARES

JUNE 2015

Background

Current Canadian tax legislation permits mining entities to issue flow-through shares to investors. Flow-through shares are securities issued to investors whereby the deductions for tax purposes related to resource exploration and evaluation expenditures (expenditures) may be claimed by investors instead of the entity, subject to a renouncement process.

Renouncement may occur:

- prospectively (i.e., the flow-through shares are issued, renouncement then occurs and eligible expenditures are incurred subsequently); or
- retrospectively (i.e., the flow-through shares are issued, eligible expenditures are then incurred and renouncement occurs subsequently).

IFRSs do not specifically address the accounting for flow-through shares or the related tax consequences arising from such transactions. Pre-changeover accounting standards, however, addressed the accounting for flow-through shares in Section 3465, *Income Taxes*, and EIC-146, *Flow-through Shares.*

Issue

How are flow-through shares accounted for under IFRSs?

Mining Industry Task Force on IFRSs

Canada's move to International Financial Reporting Standards (IFRSs) creates unique challenges for junior mining companies. Financial reporting in the sector is atypical due to significant differences in characteristics between junior mining companies and other types of companies. Chartered Professional Accountants of Canada (CPA Canada) and the Prospectors and Developers Association of Canada (PDAC) created the Mining Industry Task Force on IFRSs to share views on IFRS application issues of relevance to junior mining companies. The task force's views are provided in a series of papers that are available through free download. These views are of particular interest to chief financial officers, controllers and auditors.

The views expressed in this series are non-authoritative and have not been formally endorsed by the CPA Canada, PDAC or the organizations represented by the task force members.

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Viewpoints

The issue of flow-through shares is in substance:

- an issue of ordinary shares; and
- the sale of tax deductions.

The sale of tax deductions may be measured using either the *residual method* or the *relative fair value method.* At the time the flow-through shares are issued, the sale of tax deductions is deferred and presented as other liabilities in the statement of financial position because the entity has not yet fulfilled its obligation to pass on the tax deductions to the investor. When the entity fulfills its obligation:

- the sale of tax deductions is recognized in the income statement as either other income or a reduction of deferred tax expense (however, some are only of the view that the sale of tax deductions is recognized in the income statement as other income); and
- a deferred tax liability is recognized, in accordance with IAS 12*, Income Taxes*, for the taxable temporary difference that arises from the difference between the carrying amount of eligible expenditures capitalized as an asset in the statement of financial position and its tax base.[1]

If renouncement is prospective, the obligation is fulfilled when eligible expenditures are incurred. If renouncement is retrospective, some are only of the view that the obligation is fulfilled when eligible expenditures are incurred as long as there is the intention to renounce, some are only of the view that the obligation is fulfilled when the paperwork to renounce is filed and some find either view acceptable.

It is important to note that the renouncement of expenditures related to flow-through shares may lead to the recognition of previously unrecognized deferred tax assets.

Flow-Through Shares with Attached Share Purchase Warrants

In certain circumstances, entities may issue flow-through shares with attached share purchase warrants, which in substance represents:

- the issuance of an ordinary share;
- the sale of tax deductions (i.e., flow-through liability); and
- the issuance of a warrant.

1 With respect to retrospective renouncement, some have an alternative interpretation of the Canadian *Income Tax Act* in which eligible expenditures are deemed to never have been incurred. Under this interpretation, the *initial recognition exception* in IAS 12 would apply and the deferred tax liability would never be recognized.

On September 11, 2014, the IFRS Discussion Group ("Group")[2] discussed the accounting for flow-through shares with attached share purchase warrants.

The Group discussed how an issuer should allocate the proceeds received from the issuance of a unit comprised of a flow-through share with an attached purchase warrant classified as equity. Specifically, what measurement approaches should an issuer consider when allocating the proceeds received from the issuance of such a unit to its various components?

The Group discussed the following views:

View A — The flow-through liability should be measured at fair value, with the residual proceeds allocated within equity.

View B — Both the ordinary share and warrant should be measured at fair value with remaining proceeds allocated to the flow-through liability.

View C — Accounting policy choice.

The following content was extracted from the Groups published report — **IFRS 9 and IAS 39: Flow-through Shares with Attached Share Purchase Warrants.** To obtain a complete understanding of the Groups discussion, readers are encouraged to download and review the full report as well as listen to the accompanying audio recording of the discussion.[3]

The Group's Discussion

Some Group members expressed support for View B, while other group members expressed conceptual support for View A (i.e., measuring the flow-through liability at fair value, with the residual proceeds allocated within equity). However, practical challenges in valuing the flow-through liability may result in an approach being taken that is similar to View B. Guidance exists in IFRS 13 *Fair Value Measurement* on valuation techniques, but considerable judgment is involved given the complexity of models and certain inputs used.

Group members emphasized that, in the end, preparers should ensure the answer they have arrived at is reasonable in terms of the amounts derived for each component of the unit. Factors to consider include whether the shares are thinly traded and the financial situation of the seller (i.e., if distressed or issuing these instruments as an alternative form of financing). Disclosure on the judgment used in valuing these components should be included in the notes to the financial statements.

2 The Accounting Standards Board (AcSB) established the IFRS Discussion Group to implement and maintain a regular public forum to discuss issues that arise in Canada when applying IFRSs. These discussions are not meant to provide authoritative guidance; however, they do help clarify issues and allow interested parties to learn how others are working through their financial reporting concerns and exercising judgment in the application of IFRSs.

3 **www.frascanada.ca/international-financial-reporting-standards/ifrs-discussion-group/search-past-meeting-topics/item66541.aspx**

Members of the *Mining Industry Task Force on IFRSs* emphasize the point made by the IFRS Discussion Group that the amount allocated to each component must be reasonable.

For example, in some circumstances, to assess if the amount allocated to the flow-through liability component is reasonable it may be helpful to refer to comparable market transactions. If, for example, flow-through shares without warrants have been issued at a premium, it may be reasonable to attribute the premium to the flow-through liability component.[4] In such cases, when allocating the proceeds received from the issuance of a comparable unit comprised of a flow-through share with an attached purchase warrant classified as equity, it is likely *not* reasonable to allocate a zero value to the flow-through liability component.

Appendix

Journal Entries to Account for Flow-through Shares

PCP Ltd. is a publicly traded Canadian mining entity that prepares its financial statements in accordance with IFRSs.

Assume that:

- PCP Ltd. received $100 from the issue of flow-through shares on December 1, 20X1;
- the fair value of PCP Ltd. ordinary shares is $90 on December 1, 20X1;
- PCP Ltd. renounced with an effective date of December 31, 20X1, but filed the paperwork to renounce on January 31, 20X2;
- PCP Ltd. incurred eligible expenditures of $100 (on February 12, 20X2 for the purpose of illustrating prospective renouncement and, on December 11, 20X1 for the purpose of illustrating retrospective renouncement), which were capitalized; and
- the tax rate applicable to PCP Ltd. is 30%.

1—Issue of Ordinary Shares and Sale of Tax Deductions

The sale of tax deductions is measured at $10. In this particular case, the residual method [$100 – 90] and the relative fair value method [($100 – 90) × 100 / $100] produce the same result.

Therefore, the journal entry on December 1, 20X1, to record the issue of ordinary shares and the sale of tax deductions is:

Dr.	Cash (statement of financial position)		100	
	Cr.	Share Capital (statement of financial position)		90
	Cr.	Other Liabilities (statement of financial position)		10

4 The allocation is based on the difference between the quoted price of the Company's non-flow through shares and the amount the investor pays for the flow-through shares (given no other differences between the securities).

2—Capitalization of Eligible Expenditures

The journal entry to capitalize eligible expenditures is:

Dr.	Capitalized Eligible Expenditures (statement of financial position)	100	
	Cr. Cash (statement of financial position)		100

3—Fulfillment of Obligation and Recognition of Deferred Tax Liability

The journal entry to record the fulfillment of the obligation to pass on the tax deductions is:

Dr.	Other Liabilities (statement of financial position)	10	
	Cr. Other Income or Deferred Tax Expense (income statement)		10

The deferred tax liability is measured at \$30 [(\$100 – 0) × 30%].

The journal entry to recognize the deferred tax liability is:

Dr.	Deferred Tax Expense (income statement)	30	
	Cr. Deferred Tax Liability (statement of financial position)		30

If renouncement is prospective, these journal entries are booked on February 12, 20X2.

If renouncement is retrospective, these journal entries are booked on:

- December 11, 20X1, if the view is that the obligation is fulfilled when eligible expenditures are incurred as long as there is the intention to renounce; and
- January 31, 20X2, if the view is that the obligation is fulfilled when the paperwork to renounce is filed.

The Mining Industry Task Force on IFRSs

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For more information on IFRSs visit:

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