

## FLOW-THROUGH SHARES

# VIEWPOINTS: Applying IFRSs in the Mining Industry

## 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?

## 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

## 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. The Canadian Institute of Chartered Accountants (CICA) 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 CICA, PDAC or the organizations represented by the task force members.

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<sup>1</sup>.

If renunciation is prospective, the obligation is fulfilled when eligible expenditures are incurred. If renunciation 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 renunciation of expenditures related to flow-through shares may lead to the recognition of previously unrecognized deferred tax assets.

## 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, 2011;
- the fair value of PCP Ltd. ordinary shares is \$90 on December 1, 2011;
- PCP Ltd. renounced with an effective date of December 31, 2011, but filed the paperwork to renounce on January 31, 2012;
- PCP Ltd. incurred eligible expenditures of \$100 (on February 12, 2012 for the purpose of illustrating prospective renunciation and, on December 11, 2011 for the purpose of illustrating retrospective renunciation), 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 [ $(\$100 - 90) \times 100 / \$100$ ] produce the same result.

Therefore, the journal entry on December 1, 2011 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

<sup>1</sup> With respect to retrospective renunciation, 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.

## 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) x 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, 2012.

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

- December 11, 2011 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, 2012 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:

[www.cica.ca/IFRS](http://www.cica.ca/IFRS)