IFRS 9 and IAS 39: Flow-through Shares with Attached Share Purchase Warrants

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Current Canadian tax legislation permits entities in mining or oil and gas exploration, and entities in certain emerging technologies, to issue securities to investors whereby the deductions for tax purposes related to expenditures made previously, or in the future, may be claimed by the investors and not by the entity (commonly referred to as "flow-through shares"). The purchase of a flow-through share gives an investor the rights to a common share of the issuer and a future tax deduction equal to the cost of the initial investment.

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.

IFRSs do not explicitly address the accounting for flow-through shares or the related tax consequences arising from such transactions. The concept of flow-through shares has been discussed previously by the Group, as well as by industry groups.[1] The focus of this discussion is to deliberate specifically the accounting for flow-through shares with an attached share purchase warrant classified as equity.

Issue: How should an issuer 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?

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

On issuance, the flow-through share liability is measured at fair value with the remaining proceeds allocated within equity (for example, between common stock and warrant reserve). Absent explicit IFRS guidance on this issue, consideration may be given to IAS 18 *Revenue*, IAS 32 *Financial Instruments: Presentation* and/or IAS 39 *Financial Instruments: Recognition and Measurement*.

Paragraph 32 of IAS 32 may be helpful when determining the accounting treatment for the flow-through liability even though it is not a financial liability. When making the allocation decision, the equity component is assigned the residual amount after deducting the amount separately determined for the liability component from the fair value of the flow-through share with attached share purchase warrant as a whole.

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1 Refer to the "Viewpoint: Flow-Through Shares," prepared by the Mining Industry Task Force on IFRSs and "Viewpoint: Flow-Through Shares," prepared Oil and Gas Industry Task Force on IFRSs.

From the perspective of IAS 18, the flow-through liability can be viewed to represent the sale of future tax deductions. The obligation to fulfill this liability can be considered similar to unearned revenue. Paragraph 9 of IAS 18 requires revenue to be measured at the fair value of the consideration received or receivable.

Both of these perspectives support the view that the flow-through liability should be measured at fair value.

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

Unlike View A, since the flow-through liability is not a financial liability, guidance in IAS 32 is viewed to be less relevant. Priority is given to ensuring that the financial instrument components of the flow-through share with attached share purchase warrant (i.e., the ordinary share and the warrant) are measured at fair value based on guidance in IAS 39. The residual component is then allocated to the flow-through share liability. Similar outcomes should arise between View A and View B if the sum of the fair values of each component equals the proceeds received. However in practice, there are situations where the total fair value of the ordinary share and/or warrant exceeds the proceeds received.

View C – Accounting policy choice.

IFRSs do not specifically address the accounting for flow-through shares or the related tax consequences arising from such transactions. Paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* indicate that management should use professional judgment in developing an accounting policy in the absence of guidance. The policy selected (whether View A, View B or some other approach) should be clearly described and disclosed in the notes to the financial statements.

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.

The Group observed that this issue is unique to Canada and that the discussion raises awareness about this item. The Group did not recommend any further action be taken on this item.