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Canadian Securities Regulators Issue Guidance Regarding Cannabis-Related Disclosures

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October 12, 2018

On October 10, 2018, Staff of the Canadian Securities Administrators published a notice (the Notice) summarizing the results of a review conducted by the securities regulatory authorities in Alberta, British Columbia, Ontario and Québec of the disclosure of 70 reporting issuers in the cannabis industry. This review included reporting issuers with varying levels of involvement in the industry and with operations in different countries.

The purpose of the Notice is to highlight good disclosure practices for issuers so that investors are provided with transparent information about financial performance and risks and uncertainties, to support informed investing decisions.

The key areas highlighted were:

- Insufficient or misleading information in financial statements and MD&A related to fair value of biological assets, and related profit or loss disclosure.
- Insufficient information regarding the fair value measurement process.
- Potentially misleading non-GAAP financial measure disclosures.
- Other disclosure reminders, including with respect to forward-looking information, balanced disclosure and CSA Staff Notice 51-352 (Revised) *Issuers with U.S. Marijuana-Related Activities*.

Disclosures With Respect to Fair Value and Profit and Loss

Issuers with agricultural activities are required under International Accounting Standard 41 *Agriculture* to measure living plants, or biological assets, at their fair value, regardless of what costs may or may not be capitalized to them. The statement of profit and loss (P&L) of a cannabis cultivator therefore often includes unrealized fair value gains related to the growth of biological assets that have not yet been sold.

Many issuers in the review did not separately disclose all fair value amounts included in the P&L, often embedding adjustments in cost of good sold. IAS 1 *Presentation of Financial Statements* states that “an entity shall present additional line items…in the statement(s) presenting profit or loss and other comprehensive income when such presentation is relevant to an understanding of the entity’s financial performance” and that material income or expense items should be disclosed separately.

Recommendations and Reminders

- All fair value amounts should be separately disclosed, so that investors can understand an issuer's cost of sales excluding any fair value amounts.
- Separately disclose each of the following:
  - Unrealized gains/losses resulting from fair value changes on growth of biological assets.
  - Realized fair value amounts included in the cost of inventory sold.
- Do not aggregate fair value changes with other non-fair value items such as inventory write-downs.
- Clearly disclose:
  - What the issuer considers to be direct and indirect costs of production associated with biological assets.
  - Which P&L line item(s) direct and indirect costs are recorded in.
  - Whether direct and indirect costs of biological assets are capitalized, or whether they are expensed as incurred.
  - Avoid using "gross profit" if all direct and indirect costs related to the biological assets have not been deducted.
- For issuers that expense direct and indirect costs related to biological assets as they are incurred:
  - Provide supplemental information in their MD&A such as information about the impact that capitalization of direct and indirect costs related to biological assets would have had on the P&L, which would facilitate comparisons of gross profit between different issuers.
  - Consider whether presentation of a gross profit P&L subtotal could mislead investors as it does not consist exclusively of the direct and/or indirect costs of cannabis sold during the period.

Disclosures With Respect to the Fair Value Measurement Process

The processes and assumptions used by issuers to determine the fair value of biological assets are subjective and involve significant judgements by management at each financial reporting date. The Notice emphasized that Investors should be able to understand these judgements. Under IFRS 13 *Fair Value Measurement*, certain disclosures about these processes and assumptions are required to be made, including the valuation techniques and inputs used to develop fair value measurements and the effect of the measurements on profit or loss or other comprehensive income for the period. The review found deficient disclosure in this area for every issuer.

Recommendations and Reminders

- Provide a description of the inputs used in the fair value measurement including quantitative information about significant unobservable inputs.
- Indicate the level of the fair value hierarchy within which the fair value measurement is categorized.
- Disclose the sensitivity of the fair value measurement to changes in certain inputs.

- Discuss any interrelationships between significant unobservable inputs and how they may affect fair value measurement.

Disclosures With Respect to Non-GAAP Measures

CSA Staff Notice 52-306 (Revised) *Non-GAAP Financial Measures* sets out the regulators' expectations for the disclosure of non-GAAP financial measures in order to ensure that non-GAAP financial measures do not mislead investors. Among the guidance is an expectation that an issuer will provide a clear quantitative reconciliation from the applicable non-GAAP financial measure to the most directly comparable GAAP measure presented in its financial statements. The Notice noted that many issuers disclose a non-GAAP financial measure similar to "cash cost per gram" to portray their cost of production, after excluding non-cash fair value adjustments. The review expressed concern that the way in which this measure is calculated should be understandable to investors.

Recommendations and Reminders

- Ensure that all non-GAAP financial measures used are identified as non-GAAP financial measures and that they are reconciled to the most directly comparable GAAP measure presented in the financial statements, with the appropriate related disclosures.
- Be clear about what costs are included in the GAAP measure that formed the starting point in calculating cash cost per gram.
- Ensure that any reconciling item is sufficiently explained and that any significant judgements made in quantifying the reconciling item are also provided.

Other Disclosure Matters

The Notice covered a number of other areas related to disclosures by cannabis issuers, including:

- Reminding issuers to disclose the material factors and assumptions related to production estimates, with specific and comprehensive assumptions, particularly with respect to quantitative details, such that an investor is able to clearly understand how each assumption contributes to the projection.
- Reminding issuers to ensure that announcements about acquisitions or changes of business must be balanced so that that they are not misleading to investors.
- Indicating that licences and leases on which an issuer is substantially dependent should likely be filed as material contracts.
- Advising that issuers provide disclosure of the regulatory regimes of the foreign jurisdictions in which they have operations.
- Reminding issuers to comply with CSA Staff Notice 51-352 (Revised) *Issuers with U.S. Marijuana-Related Activities*.

The full Notice is available here.

We Can Help

For more information on how Cassels can assist with your business, please contact Greg Hogan, Shaun Khullar or another member of our firm’s cross-disciplinary Cannabis Group.
