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How to dissect the earnings of marijuana producers

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A quick look at the results of some of Canada's emerging cannabis companies shows some remarkable profitability for early-stage businesses. But a deeper dive into the financials shows the companies' results are more complex to assess than at first blush.

The culprit, if you will, is that Canadian public companies, both on the TSX and Vancouver's venture exchange, use International Financial Reporting Standards (IFRS). And these accounting rules have special requirements for natural resources – such as marijuana plants – that can greatly skew the companies' bottom-line profitability.

To explain that, let's start instead with companies that aren't in agriculture. Consider BlackBerry Ltd., when its primary business was making smartphones and tablets, BlackBerry would order all sorts of component parts to produce its finished product. Up until and during manufacturing, these parts would be called "work-in-process" inventory. When the phone or tablet was ready to sell, the parts became part of "actual for-sale" inventory. These electronic components never increased in value in any meaningful way during manufacturing; if anything, it's possible their value decreased if BlackBerry made a misstep in estimating demand and parts sat unused. Ahem.

Now, contrast that with a company whose business is growing trees or marijuana plants for sale. The business plan includes growing its product from the seed stage. For some time, the plants aren't ready to sell, so they, too, are work-in-process inventory. Unlike electrical components, though, they are likely increasing in value as they grow.

IFRS says companies must mark these biological assets to their fair value every quarter, and record the change in value in their income statements. And as companies apply the IFRS guidance, they're putting that change right up where the cost of goods appears, affecting the calculation of gross profit.

"It sounds good intellectually, but it's not particularly useful for investors interested in current profitability," says **Anthony Scilipoti**, chief executive officer of accounting-focused firm **Veritas Investment Research**. Under old Canadian GAAP, a tree could grow for five years and still be valued on the balance sheet at the historical cost of the seed. Under IFRS, which Canadian public companies adopted in 2011, "the idea is, time passes, and the plant is worth more. This is not uncommon, if you're in agriculture of any kind."

When a cannabis company is growing a lot more than it's selling, however, the end result is some seriously distorted profit numbers.

Let's look at Canopy Growth Corp. as an example. In the company's third quarter, which ended Dec. 31, the company reported $9.75-million in sales. But its "unrealized gain on changes in fair value of biological assets," which is what we call that IFRS-required markup, was $18.1-million.

The result is a gross margin – revenues minus costs of product – of $16.9-million, which is a number that's higher than the sales number. When Canopy records its other costs, the bottom line is a profit of nearly $3-million.

A better analysis of operations, however, might be to skip that fair-value change line entirely and examine these figures: Canopy's "inventory expensed to cost of sales" was $9.5-million, and "other production costs" were $1.4-million. So the company lost $1.2-million on a gross basis in the quarter, even before you factor in $12.2-million in other costs.

Canopy is an extreme example. Aphria Inc. posted $5.2-million in sales in its quarter ended Nov. 30, and adjusted its income by a fair value gain of only $74,000. And the IFRS requirement can cut both ways – Venture-traded Aurora Cannabis Inc. recorded an unrealized loss of just under $1.3-million on sales of $3.1-million in its quarter ended Sept. 30. A gross profit that would have been $1.3-million was instead a mere $86,000 when the fair-value adjustment came into play.

There are some important things to realize here: The quarterly fair-value change introduces some significant management judgment into the entire income statement; after all, the company must make estimates of how much its plants have grown, and what price they'll be sold at.

At the same time, it's not a number to be ignored entirely. To the extent management has valued its plants accurately, it's surely better to be a company where the work-in-process inventory has gained in value, rather than fallen.

However, the key takeaways for investors: "Don't get bogged down in fair value adjustments," says Canaccord Genuity associate analyst Matt Bottomley. "Look at actual product that's been sold in the market." PI Financial analyst Jason Zandberg said investors should look at operating cash flow as an operating result. And analyst Russell Stanley of Echelon Wealth Partners says "adjusted product contribution," as Canopy reports, is a more-stable, more-informative metric than what IFRS requires.

You might just conclude the cannabis industry's financials deserve a higher level of scrutiny.

With files from Brenda Bouw