THE GLOBE AND MAIL

October 12, 2018

Securities watchdogs raise red flag over disclosure issues in pot industry

DAVID MILSTEAD

PUBLISHED 2 DAYS AGOUPDATED 2 DAYS AGO

Canada's securities regulators say the cannabis industry has widespread disclosure problems that are getting in the way of investors' understanding of how to best invest in pot stocks.

Regulators in four provinces reviewed 70 publicly-listed cannabis companies, known as "issuers" in securities-industry lingo, and revealed a laundry list of problems in a Canadian Securities Administrators staff notice Wednesday.

Many had inadequate information in either their financial statements, or in the text of the management analysis that's supposed to help explain the company's financial performance. In the regulators' views, nearly three-quarters of the companies with U.S. operations failed to provide enough information about the risks of operating in that country — and therefore failed to satisfy a February CSA staff notice on how to discuss U.S. operations.

And all of the licensed cannabis producers — 100 per cent, the CSA says — needed to improve disclosure around the "fair value" of their cannabis plants, a nagging accounting issue in Canada that's been confusing investors for some time.

The Cannabis companies were responsive to regulators' concerns, the CSA said. "Where deficient disclosure was identified during our review, issuers either committed to prospective improvements or, when the deficiencies were pervasive, re-filed certain documents."

The CSA is an umbrella group for Canada's decentralized, provincial-based system of securities regulation, and acts to provide consistency across the country in the absence of a federal regulator. Provincial regulators in Alberta, British Columbia, Ontario and Québec conducted the reviews contained in Wednesday's notice.

The CSA's review is part of a broad concern in Canada about cannabis accounting. As the provincial securities regulators have reviewed company filings and engaged with the companies, Canada's Accounting Standards Board (AcSB) has conducted task force meetings to wrestle with the issues surrounding fair value.

At the same time, however, investors have bid up pot stocks in eager anticipation of what the future holds, driving shares to valuations that are disconnected with current earnings, no matter how they are reported. This leads many to question whether backward-looking financial statements are even relevant.

"We're in a nascent industry, so the financial information is less relevant in the initial stages, because investors are more interested in what's going to happen tomorrow," says ***Anthony Scilipoti***, CEO of ***Veritas Investment Research***. He contrasts this with more established companies like Dollarama, which saw its shares plunge last quarter on a missed sales estimate. "This is a fully operating company that's been going for a reasonable amount of time that you can reasonably predict what they're going to deliver. If [cannabis company] Aphria misses, sure, it's interesting, but it's not as relevant, because that same day they can say they 'we signed a deal with this company and we're building out production' and all things equal, the stock will rise."

One problem with the historical numbers is that publicly traded cannabis companies in Canada use International Accounting Standards (IAS), which are global, directed out of the United Kingdom, and didn't anticipate the issues in an emergent industry that wasn't even legal a few years ago. The international standards are considered "principles based," with less explicit guidance than in the U.S., or in the Canadian generally accepted accounting principles no longer used by public companies.

Those grey areas have created a lack of consistency in how companies report results, particularly in the application of "biological assets" standards that say companies must value their cannabis plants that are growing, but not yet ready to be sold.

Each quarter, cannabis companies assess the value of the plants in their inventory in order to place a number on the balance sheet. The change from one quarter to the next is recognized as a gain, and the income appears in the income statement, typically adding to profit.

What's confusing, however, is that the change in value of the unsold inventory is appearing near the top of the income statement, often in the cost of goods sold. In some cases, companies are reporting a gross profit — sales minus cost of sales — that's far bigger than the revenue booked in the quarter.

Securities regulators found that 71 percent of the licensed producers didn't separately disclose these fair value changes, failing to provide enough information to help investors sort this out. "It is critical for investors to be able to understand how much it costs a company to produce its product," Wednesday's staff notice reads. "Since fair value amounts in the [profit-and-loss statement] … are not costs that have been incurred related to cannabis sold, it is important for all fair value amounts to be separately disclosed, so that investors can understand a company's cost of sales excluding any fair value amounts."

Similarly, the international standards do not have explicit rules about what costs are attributable to the growth of biological assets, or whether they must be expensed immediately, appearing in the income statement, or can be "capitalized," an accounting treatment where the costs are gradually recognized over time. The CSA says many Canadian cannabis companies haven't been clear in their disclosures about what choices they've made in this regard, and could be misleading investors with their "gross profit" measures.

The CSA also said "all of the [licensed producers] we reviewed were providing deficient disclosure" in the area the processes and assumptions they were using to determine fair value.

Cannabis companies operating in the U.S. have their own disclosure challenges; since marijuana sales are allowed in many U.S. states, but still illegal at the federal level, there are a unique set of risks. And most of the companies fell short in warning their investors of them, even as regulators issued a February staff notice with guidance on the matter. Regulators' review found 74 per cent of issuers with U.S. marijuana-related activities with problems. All are taking action to improve disclosure, with 17 per cent of the companies with U.S. operations re-filing their most recent management's discussion and analysis form.