Goodmans LLP Update

CSA Provides Guidance on Disclosure Expectations for Cannabis Issuers

On October 10, 2018, the Canadian Securities Administrators (CSA) published Staff Notice 51-357 (the "**Staff Notice**"), summarizing their findings after reviewing the disclosure of 70 reporting issuers operating in the cannabis industry (the "**Review**"). The Staff Notice highlights common deficiencies and best practices for issuers in the cannabis industry, with the intent of encouraging issuers to produce transparent information pertaining to financial performance, risks and uncertainties.

In the Staff Notice, the CSA identified material deficiencies in a number of different aspects of financial reporting, as well as deficiencies on issuers' continuous disclosure records. As a follow-on to CSA Staff Notice 51-352 published on February 8, 2018 the Staff Notice also reiterated certain disclosure expectations for issuers with marijuana-related activities in the U.S. Highlights of these areas follow.

Financial Reporting

Fair Value Accounting on the Financial Statements. Issuers with agricultural activities must measure biological assets at their fair value under International Financial Reporting Standards.[1] The Review found that issuers' statement of profit and loss often included unrealized fair value gains related to the growth of biological assets that had not yet been sold. The CSA expects issuers to disclose these items separately:

- unrealized gains/losses from fair value changes on the growth of biological assets; and
- realized fair value figures included in the cost of inventory sold.

Accounting Policies Related to Biological Assets. IAS 41 requires biological assets to be measured at their fair value, regardless of what costs may or may not be capitalized to them. The Review found although most issuers disclosed a line item within the gross profit subtotal labelled 'production costs' or 'cost of goods sold', they did not describe the composition of those line items, such as whether they included all of the direct and indirect costs related to biological assets and inventory sold. The Review also determined that most issuers were not disclosing whether they were capitalizing or expensing costs directly and indirectly related to living plants. The CSA emphasizes the importance for investors to understand what costs are included in the profit and loss statement. As such, the CSA expects issuers to clearly disclose:

- direct and indirect costs of production associated with living plants;
- which profit and loss line item these costs are recorded in; and
- whether direct and indirect costs of living plants are capitalized or expensed as incurred.

Expense Costs Related to Biological Assets as Incurred. The CSA noted particular disclosure concerns relating to licensed producers who expensed all direct and indirect costs relating to living plants.

- Cost of Cannabis Sold in the Period - For issuers electing to expense direct and indirect costs relating to biological assets, the profit and loss statement will usually include incurred costs for the current period related to cannabis that has not yet been sold, making it difficult for investors to ascertain the cost of cannabis sold in the given period. The CSA encourages issuers to use their MD&A to provide supplemental information, such as the impact that capitalization of direct and indirect costs relating to biological assets would have had on the profit and loss statement. This information will allow investors to compare gross profit between issuers.
- Presentation of Gross Profit Subtotal -The CSA warned that a gross profit subtotal could be understood to consist of the direct and/or indirect costs of cannabis sold during the period. As such, a gross profit subtotal could mislead investors when the amount does not

include all of the direct and indirect costs of production for cannabis during the period. The CSA advises issuers to consider whether the presentation of a gross profit could mislead investors as a result.

Fair Value Measurement Process. The Review found that all licensed producers were providing deficient disclosure relating to the fair value of their cannabis plants. As cannabis plants progress through various stages before harvest, management needs to make judgments at each reporting date. Further, the processes and assumptions used to determine the fair value of the cannabis product must be disclosed. The CSA identified these frequently non-disclosed items:

- a description of the valuation techniques and processes;
- a description of the inputs used in the fair value measurement;
- the level of fair value hierarchy within which the fair value measurement is categorized;
- the sensitivity of the fair value measurement to changes in certain inputs; and
- a discussion pertaining to any interrelationships between unobservable inputs and how they may affect fair value measurement.[2]

Non-GAAP Financial Measures Developed in Response to Fair Value. The Review found that 48% of licensed producers use a non-GAAP financial measure to depict their cost of production, after excluding non-cash fair value adjustments. The CSA noted the following concerns and recommendations regarding the way these measures are presented:

- composition of non-GAAP financial measures were unclear due to the inability to determine what costs were included in the GAAP measure that formed the basis in calculating cash cost per gram.
- composition of a non-GAAP financial measure was also unclear due to the reconciling items used to calculate the value not being sufficiently explained. For example, many issuers did not explain significant judgments used to determine what constitutes a gram; some issuers defined a gram as a gram sold and others defined it as a gram harvested. Further, issuers distributing dried cannabis and oils failed to disclose how many grams of dried cannabis were used to produce a millilitre of oil sold.
- failure to identify a non-GAAP financial measure as a non-GAAP financial measure and to reconcile to the comparable GAAP measure provided in the financial statements.

General Review Findings

Misleading or Unbalanced Disclosure. Issuers seeking to enter or make new investments in the cannabis industry should ensure announcements are balanced and not misleading to investors. Specifically, material contingencies (such as regulatory approval as conditions to closing) and terms to events (such as termination rights if license not approved) should be discussed.

Production Estimates. Issuers making announcements pertaining to anticipated production capacity in a new facility should disclose the material factors and assumptions related to that projection. The assumptions for financial projections should be specific and comprehensive.

Impairment. For issuers with material cannabis-related assets, an impairment test should be conducted when an event occurs that could influence asset valuations. An event prompting an impairment test would include adverse changes in a regulatory framework potentially resulting in a negative impact on current or future cash flows or revenues.

Material Contracts. Issuers who are dependent on licenses to cultivate or sell cannabis, or on leased facilities to perform such activities, should file them as material contracts.

Regulatory Frameworks. Issuers with cannabis operations outside North America should disclose information pertaining to those foreign regulatory frameworks. Further, due to the illegal treatment of cannabis under U.S. federal law, issuers should monitor the evolving implications, such as the admissibility to the U.S. for those involved in the cannabis industry, and reflect these concerns in their risk factor disclosure.[3]

Issuers with U.S. Marijuana-Related Activities

The CSA restated the critical importance of disclosure expectations for issuers currently owning, or in the process of developing, marijuana-related activities in the U.S. ("**U.S. Marijuana Issuers**"). In Staff Notice 51-357, the CSA found that most U.S. Marijuana Issuers provided inadequate disclosure, and reiterated the following relevant disclosure expectations:

- A description of the issuer's involvement in the U.S. marijuana industry;
- A statement disclosing that marijuana is illegal under U.S. federal law and that enforcement of such laws is a significant risk;
- Disclosure of related risks, such as the possibility of third party service providers withdrawing services or that regulatory bodies may impose certain restrictions on the issuer's ability to operate in the U.S.;
- A discussion pertaining to the issuer's ability to access public and private capital, including the financing options available; and
- A quantification of the issuer's balance sheet and operating statement exposure to U.S. marijuana-related activities.

Additional disclosure may be required dependent upon whether the issuer has a direct, indirect or ancillary involvement with U.S. marijuana-related activities.

For further information on the Staff Notice or continuous disclosure requirements, please contact any member of our Corporate and Commercial Law Group.

[1] Per International Accounting Standards (IAS) 41 *Agriculture*, biological assets include living plants and animals.

[2] For example, unobservable inputs may include selling price, stage of growth, yield by plant, wastage and post-harvest costs.

[3] In a clarification issued on October 9, U.S. Customs and Border Protection noted that "a Canadian citizen working in or facilitating the proliferation of the legal marijuana industry in Canada, *coming to the U.S. for reasons unrelated to the marijuana industry* will generally be admissible to the U.S." (Emphasis added.)

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