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CSA PUBLISHES REVIEW OF DISCLOSURE OF REPORTING ISSUERS IN THE CANNABIS INDUSTRY

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On October 10, 2018, the Canadian Securities Administrators (the "**CSA**") published <u>CSA Staff Notice 51-357 Staff</u> <u>Review of Reporting Issuers in the Cannabis Industry</u> (the "**CSA Notice 51-357**"), which summarizes a review of 70 reporting issuers' disclosure practice, and highlights common deficiencies and best practices.

The CSA identified three key areas where the CSA expects issuers to improve their disclosure:

- The financial statements and management's discussion and analysis ("**MD&A**") of licensed cannabis producers ("**LPs**") need to be improved to allow an investor to understand their financial performance. Specifically, LPs should improve their fair value and fair value related disclosures.
- Some issuers did not consistently comply with securities requirements for forward-looking information, guidance for providing balanced disclosure and other requirements.
- 74% of issuers with cannabis operations in the United States did not provide sufficient disclosure as required pursuant to CSA Staff Notice 51-352 (Revised) Issuers with U.S. Marijuana-Related Activities (the "US Disclosure Expectations Notice").

Certain issuers were required to refile certain documents if the deficiencies were pervasive. We recommend that issuers consult their securities legal counsel to strengthen their compliance with their disclosure obligations.

Common Disclosure Inefficiencies

Disclosure about the Impact of Fair Value Accounting on Financial Statements

LPs are often including fair value adjustments in the 'cost of goods sold' in their statements of profit and loss ("**P&L**"). Issuers with agricultural operations are required to measure biological assets (i.e. living plants) at their fair value under the International Financial Reporting Standards. Since fair value amounts in the P&L of a LP are not costs incurred related to cannabis sold, fair value amounts must be separately disclosed so that investors can understand a company's financial performance. The CSA expects issuers to separately disclose unrealized gains and or losses due to fair value changes on growth of biological assets, and realized fair value amounts included in the cost of inventory sold.

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Disclosure of Accounting Policies Related to Biological Assets

While most issuers had a P&L line item within the gross profit subtotal called 'production costs' or 'costs of goods sold', they failed to breakdown the composition of the item. This can be misleading for investors as the item may be interpreted as revenue less costs of goods sold, without the indication that not all direct and/or indirect costs of production are included in that item. The CSA expects issuers to clearly disclose what it considers to be a direct or indirect cost of production associated with biological assets, which P&L line item(s) these direct and indirect costs are recorded in, and whether the direct/indirect costs of biological assets are capitalized or expensed as incurred.

Disclosure Issues for LPs that Expense Costs Related to Biological Assets as Incurred

Disclosure about the Cost of Cannabis Sold in the Period

Investors may need information about the cost of cannabis sold in the period regardless of whether the issuer elects to capitalize or expense biological assets. The CSA, therefore, encourages issuers who expense biological assets as incurred to provide supplemental information in their MD&A, such as the impact that capitalization of direct and indirect costs related to biological assets would have had on the P&L.

Presentation of a Gross Profit Subtotal

Issuers that expense direct and indirect costs of biological assets should consider an alternative to a mere 'gross profit' subtotal item in their P&L, to make explicit that costs of these assets includes costs incurred on good which have not yet been sold.

Disclosure about the Fair Value Measurement Process

Investors must be able to understand the judgements management makes about growing cannabis plants at various stages prior to harvest. The CSA Notice 51-357 notes that all of the LPs they reviewed were providing deficient disclosure in this area. The CSA Notice 51-357 provides examples of how the disclosure can be improved, including, amongst others, providing a description of the valuation techniques and processes.

Disclosure about Non-GAAP Financial Measures Developed in Response to Fair Value

Licensed producers must clearly disclose how they calculate non-GAAP financial measures, similar to 'cash cost per gram', to show the cost of production after excluding non-cash fair value adjustments. For example, they should specifically identify those financial measures as 'non-GAAP measures', and describe what costs were included in the GAAP measure that formed the starting point in calculating cost per gram. Issuers should also ensure that reconciling items and assumptions used to calculate non-GAAP measures are fully explained.

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Language of Disclosure

Issuers must use specific and comprehensive quantitative detail when disclosing material factors and assumptions related to production estimates of new facilities under construction. In addition, the CSA reminds issuers to outline any material contingencies and terms to ensure that they are providing balanced disclosure—including any applicable foreign regulatory frameworks.

Issuers with U.S. Marijuana-Related Activities

The CSA cited inadequate disclosure by most issuers with cannabis operations in the United States. At minimum, issuers are expected to disclose:

- a description of the nature of the issuer's involvement in the United States cannabis industry;
- that marijuana is illegal under U.S. federal law and that enforcement is a risk;
- related risks, such as third party service providers terminating service;
- information about the issuer's ability to access public and private capital;
- quantification of their balance sheet and operating statement exposure to U.S. marijuana-related activities; and
- additional disclosures depending on whether the issuer's involvement with

U.S. marijuana-related activities is direct, indirect, or ancillary. For further information, see the <u>U.S. Disclosure Expectations Notice</u>.

Moving Forward

The cannabis industry has grown significantly as an emerging public market sector and we can expect that the CSA will review other disclosure requirements not outlined in the CSA Notice 51-357. We expect that the CSA may take a closer review of the marketing materials that are presented to potential investors as issuers are vamping up their financing efforts.

For further information on the CSA Notice 51-357 or continuous disclosure requirements, please contact any member of our Cannabis Group.

by Marina Tran and Marta Miazek (Articled Student)

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

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