



Auditing in the cannabis sector

Since its legalization in Canada in 2018, the cannabis industry has seen unprecedented volatility in the capital markets. At the time of this publication, there are more than 250 Canadian reporting issuers in this sector. Over the past two years the Canadian Public Accountability Board (CPAB) has reviewed the quality of audits of cannabis companies to better understand how auditors have adapted to the challenges in this emerging industry.

WHAT WE FOUND

CPAB inspected a total of 42 cannabis audit files over 2019-2020 and found significant findings in 22 of those files. These findings¹ emphasize that immediate action is necessary to improve audit quality and to protect capital markets.

Four most common significant deficiencies

- 1** Insufficient understanding of the entity and its environment.
- 2** Inadequate fraud risk assessment and audit response in companies operating in foreign jurisdictions where banking services are limited.
- 3** Lack of evidence to support key inputs used in the fair value of biological assets.
- 4** Inadequate procedures to support biological assets and inventory quantities.



¹A significant finding is a significant deficiency in the application of generally accepted auditing standards, related to a material financial balance or transaction stream, where the audit firm must perform additional audit work, to support the audit opinion and/or is required to make significant changes to its audit approach. These are reported to the firm in an engagement findings report (EFR) and referred to as EFR Is and require a written response from the engagement team.



1. Understanding the entity and its environment

The auditor's understanding of the company and its environment, including internal controls and its legal environment, is essential to the auditors' planning and executing of the audit. We identified inconsistencies in the auditor's risk assessment and audit procedures performed related to compliance with laws and regulations and fraud.

Laws and regulations

Non-compliance with laws and regulations may result in monetary fines, license revocation or other consequences as described by the relevant regulators and could have a material impact on the financial statements. Accordingly, it is critical that auditors understand the laws and regulations, policies, procedures, and internal controls the company has implemented to prevent and detect non-compliance with applicable laws and regulations. Examples of deficiencies we identified:

- No reconciliation between the grow areas and the quantity of inventory on hand to the approved licenses or license applications.
- Limited or no understanding of the company's standard operating procedures related to access to the inventory in drying rooms and the consequential impact on the auditor's ability to perform inventory count observations over material inventory balances at year end.

Fraud risk assessment

A significant risk of material misstatement due to fraud or error exists for cannabis companies with complex organizational structures, lack of internal controls and limited access to banking services. In our inspections we found instances of limited consideration of the impact of prominent fraud risk factors, including:

- Incentives/pressures to commit fraud including high levels of competition, significant volatility in the markets and stringent regulatory requirements.
- Opportunities to commit fraud including complex organizational structures, lack of monitoring of financial reporting or ineffective internal controls (e.g., over the cash cycle including receipts and disbursements in predominately cash-based businesses).
- The presence of potential attitudes/rationalizations including a lack of timely remediation by management of known internal control deficiencies.

2. Fraud risk assessment and audit response in companies operating in foreign jurisdictions where banking services are limited



Companies that operate in certain jurisdictions such as the United States face challenges which limit access to certain banking services. As a result, a significant portion of the revenues earned and expenses incurred are transacted in cash. The large volume of cash receipts and disbursements significantly increases the risks of misappropriation and risk of unrecorded cash transactions. In our inspections we identified concerns with the work performed to address the risks of material misstatement due to fraud or error related to the occurrence and completeness of revenue including:

- Inadequate evaluation of the design and implementation of controls over the cash cycle (i. e., receipts and disbursements) and impact of identified control deficiencies.
- Audit procedures limited to agreeing sales to the cash reconciliation without obtaining evidence that cannabis was delivered and that sales were made to valid customers (i.e., valid license and/or prescription).
- In many instances, no procedures were performed to support the validity of cash disbursements and transfers of cash included in the cash reconciliation.



3. Estimates used in the valuation of biological assets

Cannabis plants, up to and including the point of harvest, are considered to be biological assets by International Financial Reporting Standards (IFRS)². Under IFRS biological assets are required to be measured and reported at fair value each reporting period. In our inspections we found instances where auditors did not obtain sufficient appropriate evidence to support certain key inputs which have a material impact on these fair value calculations, including yields and lifecycle and estimated selling price.

Yields and lifecycle

The estimated yield used in the fair value model is the quantity of cannabis from the plant at various stages in its lifecycle at the end of the reporting period. Yields and lifecycle of the plant are key estimates that require significant judgment by management. These judgments vary based on factors such as strain and grow conditions. For example, certain strains have larger yields or a range of lifecycles and growing indoors can shorten the lifecycle versus growing outdoors.

We noted instances in our inspections where auditors relied on either internal or external information to support the yields and lifecycle estimates without performing adequate procedures to support the relevance and reliability of the information used to develop these estimates. For example:

- No procedures were performed such as site visits to observe plant counts by strain at different stages of the plant's lifecycle to support the lifecycle estimates or to weigh the plants once dried to support the yield estimates.
- Where auditors performed observations over dried inventory to evaluate yields there was limited corroboration and consideration of whether the yields were consistent with the information reported in the company's internal records (e.g., harvest logs).
- Where external information like competitor or industry yields was used there was no evaluation of whether it was comparable to the company's operations. For example, external information was used for companies with different grow facilities (outdoor versus indoor grow).

Selling price

Selling prices vary significantly across different products, customer base, jurisdictions and regions. A selling price that does not reflect the expected market may significantly impact the amounts reported as biological assets.

We found instances in our inspections where auditors relied on historical prices and wholesale contract prices in the fair value model with limited testing of whether these prices reflected fair value, such as comparison to published prices from regulatory bodies or adjustments for excise taxes and discounts.

² As defined under International Accounting Standards: IAS 41 Agriculture



4. Biological assets and inventory

The regulatory requirement that cannabis companies track their products from seed to sale creates complex reporting requirements. This requires companies to use certain approved information technology (IT) applications to track and report key aspects of their operations and to develop standard procedures that define and guide how the company operates.

Reliance on key IT applications

In certain instances, we found that auditors did not identify the risks associated with the reliability of the information (e.g., harvest logs) prepared by the entity. This information was obtained from key IT applications, such as Health Canada's Cannabis Tracking and Licensing System (CTLS) and Marijuana Enforcement Tracking and Reporting & Compliance (METRC), without adequate consideration of whether the information can be modified and that access to the IT applications is restricted to the appropriate personnel. This lack of consideration of the risks and limited audit procedures over access may impact the completeness and accuracy of the quantities reported in the fair value model.

Inventory counts

Due to the nature of cannabis plants and products, the risks of contamination could make observing physical counts more challenging. We noted many instances where auditors did not obtain an understanding of the company's standard operating procedures to determine if access to these locations was permissible, and either did not design and execute appropriate audit procedures at alternative dates or did not perform alternative procedures to support the existence, completeness and condition of inventory. For example, we found:

- Limited observations of the inventory counts of material cannabis inventory amounts located in drying rooms.
- Where observations were performed there were inadequate procedures to reconcile the quantities reported in the manual harvest logs and/or reports generated from key IT applications.

WHAT'S NEXT?

We encourage auditors to discuss these findings with their engagement teams, the reporting issuer's audit committee and Chief Financial Officer. Immediate implementation of changes to the audit approach may be necessary to ensure that the audit is appropriately designed to identify and remediate deficiencies in financial reporting and internal controls.

Learn More

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