Are Marijuana Companies Reporting Fictitious Earnings?

Description

Investors love to invest companies that generate profits, or they want to at least own stocks that have the potential to generate sustainable profitability. The investing community demands regular performance updates in the form of financial reports. While the need to impress investors is creating pressure for the infant marijuana industry, are the companies fairly reporting performance?

Investors reading through the financial statements of the three leading marijuana producers — **Canopy Growth Corp**. (TSX:WEED), **Aphria Inc,** (TSXV:APH), and **Aurora Cannabis Inc.** (TSXV:ACB) — are becoming worried about the prevalence of a one line item within the cost of sales titled "unrealized gain on changes in fair value of biological assets" (Canopy), "net effect of unrealized changes in fair value of biological assets" (Aphria) or "unrealized gain on changes in fair value of biological assets" (Aurora Cannabis).

Why are investors worried?

This single line item, especially for Canopy and Aurora Cannabis, has become a major driver for profitability. It was the critical figure that led Canopy to turn a more than $5 million operating loss into $4.75 million operating profit in the recent earnings report!

Most interesting, Canopy went on to recover the costs of goods sold by $7.191 million, leading to a gross profit of $16.94 million from sales of just $9.752 million!

Isn't this amazing?

Don't panic

The new marijuana industry is just a growing niche in the Canadian agricultural sector. Under International Financial Reporting Standards (IFRS), agricultural firms, such as farmers or livestock growers, are thus permitted to recognize the growth and increase in the value of their biological assets in earnings reports as gains and losses in the income statement.

Emerging marijuana producers are all in a phenomenal growth phase, making haste before the anticipated legalization of recreational marijuana. The firms are beefing up their ammunition for the cut-throat competition ahead; growing productive assets and inventory stockpiles are of critical importance right now.

So, the resultant growth in the biological assets portfolios and the unrealized gains should not be so concerning. Rather, the lack thereof should trigger worries that the firm may fail to match the competition in the new recreational market. The growth in biological assets should bring more confidence because management is working hard and growing the company as fast as is necessary.

We therefore can't conclude there is fictitious accounting yet.

Investor takeaway

It is a good thing that some investors and analysts are raising some concerns. It shows that at least some analysis work, not mere speculation, is going into marijuana stock selection, and therefore investment funds are being channeled to the most efficient or promising producers.

Normal startups are expected to somehow make initial losses before they find their feet and eventually grow in profitability as growth opportunities are capitalized on.

However, I do not wish to continuously see unrealized gains being the major driver of industry profitability for too long as that is not sustainable. Revenue growth and low corporate costs should drive dependable profitability.

In-depth analysis will drive value for investors going forward. For this reason, *The Motley Fool* offers the *Motley Fool Pro* service to those keen on gaining more valuable insights from highly experienced professionals.

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