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Corporations Department

Staff Accounting Bulletin

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August 4, 2020/14 Av. 5780

SAB 23-1: Disclosure of Assumptions used to Estimate Net Fair Value of Biological Assets in Medical Cannabis Corporations

Background

In recent years, a series of corporations in the field of medical cannabis have listed for trading on the Tel Aviv Stock Exchange ("the Medical Cannabis Corporations" or "the Corporations") and at the same time significant regulatory changes have occurred in this field.[1] In several inspections by ISA Staff of the disclosures made by the Medical Cannabis Corporations and measurements of the net fair value of the biological assets they own, ISA Staff found inadequate disclosures about the material assumptions used to measure the net fair value of these assets, as required by accounting standards (defined below). The aim of this Staff Bulletin is, therefore, to improve the disclosures made by the Medical Cannabis Corporations on this matter. Such disclosures have become even more important in view of the new regulation on medical cannabis and its potential implications on net fair value measurements of biological assets in medical cannabis corporations.

International Accounting Standard 41 ("IAS 41") defines the rules for measurement and disclosures concerning biological assets such as cannabis plants for commercial sale of its cultivated plants (flowers and other related products) and the agricultural produce at the point of harvest, cultivated from the biological assets.

According to IAS 41, a biological asset must be measured on initial recognition and at the end of each reporting period at its fair value less costs to sell[2] ("Net Fair Value"). Agricultural produce harvested from an entity's biological assets must be measured at the point of harvest in a similar manner, and beginning from this date onward is classified as an inventory asset.[3] For the purpose of defining fair value, IAS 41[4] refers to the provisions of International Financial Reporting Standard 13 – Fair Value Measurement ("IFRS 13"). International Accounting Standard 1 Presentation of Financial Statements ("IAS 1"; jointly, "the Accounting Standards")) sets out the required disclosure regarding material estimates in a entity's financial statements.

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[1] With an emphasis on the new regulatory regime for the medical cannabis industry, as published in the Road Map of the Medical Cannabis Unit at the Ministry of Health ("the new regulatory regime"):

[2] IAS 41.12.

[3] IAS 41.13.

[4] IAS 41.8.

The medical cannabis market is not currently a homogeneous market and furthermore has numerous regulatory barriers. As a result, medical cannabis corporations may be required to use extensive judgments regarding the assumptions, estimates, and projections required to estimate net fair value.

For example, according to the previous regulatory regime, medical cannabis patients paid a fixed price for each treatment, irrespective of the quantity consumed. As a result, the method used to estimate the value of a corporation's biological assets typically relied on the ratio of the medical cannabis corporation's estimated revenues (determined on the basis of the number of patients multiplied by the fixed price) to the estimated quantity of oil and/or flowers that the corporation was required to harvest to generate these revenues.

In contrast to the past, when consumer price was a fixed per-monthly fee, under the new regulatory regime, the consumer price is based on weight purchased and is a function of market forces. This change may affect the method used in the field of medical cannabis to estimate the value of the biological assets being cultivated and/or the agricultural produce at the point of harvest ("Medical Cannabis Assets"). Therefore, estimates sales prices may now involve a more extensive use of judgments and estimates than under the previous regime. Consequently, the net fair value estimates of medical cannabis assets must be well established, and a full disclosure of these estimates is required, pursuant to the requirements of the relevant accounting standards.

Key Guidelines Concerning the Required Disclosure of the Main Assumptions Underlying the Net Fair Value Estimate

IFRS 13[5] sets out the disclosure requirements that apply to assets periodically measured at fair value, based on significant unobservable inputs (Level 3), among other things. According to these provisions, an entity must also address the following issues, and also make additional disclosure requirements:

(a) The level of the fair value hierarchy within which the fair value measurements are categorized (Level 1, 2, or 3);

[5] IFRS 13.91-99.

(b) A description of the valuation technique(s), the assessment procedures, and the inputs used in the fair value measurement;

(c) Quantitative information about the significant unobservable inputs used in the fair value measurement;

(d) A narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs if a change in those inputs to a different amount might result a significantly higher or lower fair value measurement.

Furthermore, pursuant to the provisions of IAS 1, a disclosure is required of the judgments that were used by the entity's management in implementing the entity's accounting policy, and that have the most significant effect on the amounts recognized in the financial statements.[6] Furthermore, a disclosure of information concerning the entity's assumptions concerning the future, and other major sources of estimation uncertainty included in the financial statements.[7] An estimate of the net fair value of biological assets of medical cannabis corporations may, at a high rate of probability, be a significant accounting estimate, depending on the circumstances. Therefore, the disclosure of the net fair value estimate should be included according to the provisions of the Accounting Standards, including the main assumptions used to calculate this estimate.

ISA Staff emphasizes that the required disclosure of the net fair value estimate of medical cannabis assets according to the Accounting Standards must include reference to all the material assumptions, as appropriate and relevant, subject to the materiality of each assumption taken alone. For the sake of uniformity, this information may be contained in a tabular disclosure (the mean values for the corporation's medical cannabis assets that were estimated together in the valuation). For the sake of illustration, the following example presents possible material assumptions and key parameters frequently used in estimating net fair value of medical cannabis assets, identified in the ISA Staff's inspections of the financial statements of the Medical Cannabis Corporations, when the new regulation came into force and thereafter. ISA Staff emphasizes that the following table and the parameters contained therein are presented solely for the sake of

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[6] IAS 1.122.

[7] IAS 1.125 refers to estimates that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities (material estimates).

illustration, and the required disclosure must include the information that is appropriate according to the circumstances of the case.[8]

	December 31, 20X0	December 31, 20X1
Net cultivation area (in dunams)	3 dunams	5 dunams
Estimates sales price[9] (NIS/gr)	NIS 6-8	NIS 4-6
Net estimated yield [10] (kgs[11])	175 kgs	250 kgs
Estimated proportion of the products that will be sold as medical cannabis oil/dry medical cannabis (%)	Medical cannabis oil – 60% Dry medical cannabis – 40%	Medical cannabis oil – 70% Dry medical cannabis – 30%
Estimated growth cycle (weeks)[12]	14 weeks	16 weeks
Estimated growth cycle completion rate (%)[13]	50%	70%

Moreover, according to IAS 1, as stated above, a disclosure of material estimates that makes it possible to understand the management's use of judgments concerning the future and other factors that potentially add estimation

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[8] With respect to all these sections, we note that the disclosure should add any historical means (sales prices, length of growth cycle, etc.) used to establish the various assumptions.

[9] In lieu of precise details of the projected mean sales price, a reasonable range of sales prices in the corporation's main target markets may be included. Alternatively, if the company relied on the company's mean sales prices in previous periods as properly representing the company's estimated future sales price, this estimate may be included with a note on that fact.

[10] Gross estimated yield less wastage. Alternatively, if the valuation was based on estimated yield per plant (in gr.), this estimate should be included.

[11] The above disclosure should include the quantity of dry produce of flowers and/or other products that the company cultivates.

[12] For estimating the net fair value of the biological assets that have not yet been harvested.

[13] For estimating the net fair value of the biological assets that have not yet been harvested.

uncertainty. The scope and the materiality of the information disclosed vary according to the materiality of the assumptions and other circumstances. Examples include, but are not limited to, the carrying amounts' sensitivity to methods, assumptions, and estimates underlying their calculation, including the cause of the sensitivity, and other factors.[14] As noted above, IFRS 13 also defined additional disclosure requirements on this matter. Therefore, the disclosure of net fair value estimates of biological assets in medical cannabis corporations should include analyses of net fair value measurements' sensitivity to the main assumptions underlying these measurements.

A medical cannabis corporation that failed to include a full disclosure of the main assumptions used to estimate net fair value in the format appearing above or in a similar format that meets the Accounting Standards' disclosure requirements, must include this disclosure in its forthcoming periodic financial statements.

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[14] IAS 1.129.