

High on Hemp: The Meteoric Rise and Fall of Canopy Growth Corporation

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The purpose of this case study is to critically review: (1) the reasons for the meteoric growth of Canopy Growth Corporation (CGC), a Canadian company listed in the U.S., the company's ability to capitalize on investor sentiments related to the demand for cannabis products, and the explanations for its expansionary business strategy, (2) whether upon realizing that the regulatory environment was unlikely to change favorably, the company made adequate disclosures to warn investors about a potential decline in future revenues because of insufficient demand, (3) the adverse impact of the company's aggressive reporting and inadequate disclosures practices, and (4) the collective reasons for the erosion in shareholder wealth.

Expectations of deregulation in a highly regulated industry can offer rich rewards to investors. However, the downside is that if companies fail to revise their expectations once they realize that their projections are overly optimistic and no longer realizable, society at large is the loser. Our case study underscores that companies must disclose, even proprietary, bad news promptly, especially when such news follows a period of lofty expectations. Should they not disclose such bad news promptly for various agency reasons, the long-term consequences would be catastrophic. We demonstrate this type of cost using CGC as a case study.

Canopy Growth Corporation (CGC)

Founded by Bruce Linton and Chuck Rifici in 2013, Canopy Growth, formerly Tweed Marijuana Inc., received its license to sell medical marijuana in Canada in 2014 (Levick, 2021). In April 2014, Tweed was listed on the Toronto Stock Exchange and the company became the first federally licensed, regulated, and publicly traded cannabis producer in North America (Levick, 2021). After merging with Bedrocan Canada in 2015, the company was renamed Canopy Growth with two established brands: Tweed and Bedrocan. Continuing its growth story, the company in 2016 launched new cannabis products with rapper Snoop Dogg (Levick, 2021). Nearly tripling its production and processing capacity, Canopy Growth purchased the former Hershey chocolate factory in 2017 (Kolmar, 2023). The company was also listed on the New York Stock Exchange in 2018 (the company now trades on the NASDAQ). The same year, Canopy Growth formed a \$5-billion CAD partnership with Constellation Brands, an alcohol-based company that now owns 38% of the company (Kolmar, 2023). Leveraging its cash infusion from Constellation Brands, Canopy Growth made plans to expand its operations in global markets, notably in Germany, Spain, and Australia. The growth in cannabis demand was expected to explode in North America because marijuana for recreational use became legal in Canada in 2018 (Levick, 2021).

Background on Hemp Production and Distribution

Both hemp and marijuana belong to the same species, *cannabis sativa*. The identifying differentiation between hemp and marijuana is the psychoactive component: tetrahydrocannabinol, or THC. Hemp has 0.3% or less THC, which means that hemp-based derivatives do not contain sufficient THC to create the "high" traditionally associated with marijuana (Malone, 2021). Marijuana and hemp were effectively made illegal in the United States in 1937, and there was an outright ban on these products from 1970.

However, in pivotal regulation, the Agriculture Improvement Act of 2018 (2018 Farm Bill) authorized the production of hemp and removed hemp and hemp seeds from DEA's schedule of Controlled Substances.¹ Several states including

¹ The 2018 Farm Bill imposed several restrictions. First, hemp cannot contain more than 0.3% THC. If hemp does, then the product would be considered non-hemp cannabis—or marijuana—under federal law and would not qualify for legal protection under this new legislation. Second, regulatory powers would be shared between state and federal agencies over hemp cultivation and production. Third,

Colorado, Oregon and Nevada also legalized the use marijuana (James and Tippins 2021). In sharp contrast to the U.S. regulations related to marijuana and hemp, there are no federal bans on the sale of marijuana in Canada. While medical marijuana is legal, Canada is considering regulations to legalize cannabis for recreational use as well. Because of these regulatory reasons, the Canadian stock exchange became a haven for companies considering the production and distribution of cannabis. Although Canadian companies can list on U.S. stock exchanges, U.S. marijuana companies are precluded from listing on a U.S. stock exchange because of the federal ban.

High on Growth: May 2018 to February 2021

The company started trading in the U.S. on the New York Stock Exchange from May 24, 2018, under the ticker symbol CGC (prior to this period, the company was trading as OTC Pink, under the symbol TWMJF). As of September 30, 2019, CGC is required to prepare its financial statements filed with the SEC in accordance with generally accepted accounting principles in the United States (“U.S. GAAP”).² The trading price of the stock was around \$2 CAD. Between 2018 and early 2021, the stock went up by 20 times (from about \$2 CAD to a high of \$40 CAD) and became the largest cannabis stock in the world, with a market capitalization of more than \$9 billion CAD (PR Newswire May 23, 2018).

Despite not being profitable between 2018 and 2021, the company’s growth in revenues was spectacular. Canopy Growth was synonymous with a “growth” story. See Table 1, pg. 337, for the details on revenue growth and earnings growth.

Lofty Market Expectations

According to the United Nations Office of Drugs and Crime, cannabis is widely seen as the most extensively available drug worldwide. Cannabis is grown in 135 countries representing 92% of the world's population (Parker, Mattia, Shaik, Ortega, Whittle 2019). When considering the medical and therapeutic benefits, several countries legalized cannabis cultivation sale and use of the product. Other countries including Uruguay, Canada, Spain, Netherlands, and India have either passed or expected to pass legislation to permit the recreational use of cannabis (Kalvabelle, 2017).

In the U.S., the market size of cannabis consumption (legal and illegal) was estimated to be between \$45 and \$50 billion in 2017. The projections support the argument that cannabis demand rivals the demand of soybeans. With the expected legalization of cannabis worldwide, the potential for future profits and growth in the demand for cannabis was a widely accepted prevailing around 2019. According to Parker et al. (2019), the combined projected demand for marijuana in 2019 was expected to reach between \$12 and \$17 billion by 2021.

Growth an Illusion: March 2021 to December 2022

However, from March 2021, the stock price started to decline almost monotonically, and by July 2022, the stock was trading around \$2 CAD. As illustrated in Figures 1 and 2, the stock price evolution reflects the reversal of annual revenue growth and other financial struggles faced by CGC during this period. A key reason for the decline in the stock price was the reversal in its annual revenue growth. In 2022, the reported annual revenues were \$510 million CAD, a decline of 7% relative to the 2021 number.

Compounding Canopy Growth’s decline in revenue, on June 7, 2022, the U.S. District Court approved a \$13 million CAD settlement with Canopy Growth Corporation Defendants.³ A securities fraud class action was filed on behalf of all purchasers of Canopy Growth Corporation between June 27, 2018, and May 28, 2020. The lawsuit alleged that the Defendants misrepresented and concealed material facts about Canopy's financial results, business, operations, and prospects. Specifically, the company promoted strong demand for its cannabis products when, in reality, this company was experiencing a weak demand. The lawsuit also alleged that the value of the Company’s aging biological assets was materially overstated. Consequently, the Company’s securities traded at artificially inflated prices throughout the class period.⁴

the law outlines actions that are considered violations of federal hemp law, including cultivating without a license or producing cannabis with more than 0.3% THC. Fourth, the cultivation and production of hemp, while legal, remains highly regulated for personal and industrial production.

² <https://www.canopygrowth.com/wp-content/uploads/2020/07/Q3-FY2020-US-GAAP-Refiled-Financial-Statements-Final.pdf>

³ There is no SEC or enforcement actions associated with any of the financial reporting problems of CGC. This absence of regulatory scrutiny is noteworthy, considering the severity of CGC's financial misstatements and internal control weaknesses.

⁴ See co-lead counsel Hagens and Berman’s report (Case number: 2:19-cv-20543-KM-ESK). <https://www.hbsslaw.com/cases/cgc>.

While litigation accelerated the erosion of CGC's market value, it also underscores the reputational damages that arise from governance failures. These lawsuits highlight the critical role that transparency and strong internal controls play in safeguarding investor trust, particularly in nascent, high-risk industries. This lawsuit settlement was a precursor to CGC's financial woes in the subsequent year.

Financial Reporting Deliriums: 2023

May 10, 2023 (8-K): Non-Reliance on Previously Issued Financial Statements or a Related Audit Report or Completed Interim Review

During the preparation of Canopy Growth Corporation's consolidated financial statements for the fiscal year ended March 31, 2023, management of the Company identified certain trends in the booking of sales by the BioSteel Sports Nutrition Inc. business unit for further review. Thereafter, management of the company in conjunction with an independent external counsel and forensic accountants and under the oversight of the Audit Committee of the Board of Directors initiated an internal review of the financial reporting matters related to BioSteel in early 2023.

Based on this internal review, the Company disclosed that it identified material misstatements in the Prior Financial Statements related to sales in the BioSteel business unit that were accounted for incorrectly. Figures 1 and 2 illustrate the significant stock price changes, correlating with key financial events such as the restatement of financial statements and the 2023 disclosures. The conclusion was that the Company's: (i) audited consolidated financial statements for the fiscal year ended March 31, 2022 (included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2022) and (ii) unaudited consolidated financial statements for the quarterly periods ended June 30, 2022, September 30, 2022 and December 31, 2022 (included in the Company's Quarterly Reports on Form 10-Q) should no longer be relied upon because of certain material misstatements contained in the prior period financial statements. Therefore, the restatement of the prior period financial statements would be material error corrections which are popularly known as "Big R" restatements.

Additionally, the reports of the Company's independent registered public accounting firm (KPMG, LLC) included in the 2022 10-K should no longer be relied upon. The expectation was that the correction of the misstatements would reduce revenues previously recognized and adjust related balance sheet items, including certain segment disclosures.

The preliminary findings of the ongoing BioSteel Review, including the discovery of misstatements, resulted in the Company reassessing its disclosure controls and procedures, as well as internal control over financial reporting. The Company noted that it expected to report one or more material weaknesses in internal control over financial reporting.

Because the reporting error was deemed material to the prior period financial statements, the company was forced to restate its prior period financial statements. This type of serious error correction indicates that management failed to maintain effective internal control over financial reporting to generate reliable financial statements. The audit committee also failed in its oversight of the company's financial reporting environment. The auditors also failed to detect the material misstatement when it occurred. Because the error was material, the internal control over financial reporting would also be deemed ineffective.

May 26, 2023 (NT 10-K): Notification of Late Filing

Because of the BioSteel review and the pending restatements, the Company disclosed that it was unable to complete its financial statements and file its Annual Report on Form 10-K for the year ended March 31, 2023, by the prescribed due date for such filing.

June 22, 2023 (10-K): Filing of the 10-K and Restatement of 2022 Financial Statements

In the 2023 10-K, the company disclosed the details related to the misstatements in its 2022 financial statements.

Misstatement with Revenue Recognition

With the oversight of the Audit Committee, CGC launched an internal review, together with independent external counsel and forensic accountants. This review identified material misstatements in certain of CGC's prior financial statements related to certain sales in the BioSteel business unit. The sale of BioSteel business unit was accounted for incorrectly because the timing of the revenue recognition was not in accordance with U.S. GAAP as outlined under ASC 606, *Revenue from*

Contracts with Customers. The correction of the revenue misstatement resulted in a decrease of approximately \$10.0 million CAD in net revenue for the year ended March 31, 2022, or approximately 2% of total net revenue.⁵

Reasons of the Misstatements

The discovery of this material misstatement highlights significant weaknesses in CGC's internal control environment, particularly in relation to revenue recognition practices. It also raises questions about the corporate governance and oversight mechanisms in place during this period. While the Audit Committee's involvement in launching the review is commendable, the initial failure to adhere to U.S. GAAP guidelines, specifically ASC 606, suggests deeper issues within the company's financial reporting processes. This misstatement not only impacted the company's financial statements but also eroded investor trust, as it came after a series of aggressive expansion moves by CGC. The lack of timely disclosure and transparent financial reporting likely contributed to a culture of over-optimism, fueled by leadership's pressure to meet high growth expectations. Additionally, the role of external auditors must be scrutinized—while KPMG ultimately identified these issues, their initial audits did not catch the discrepancies, underscoring the importance of a robust auditing process.

Goodwill Impairment

A valuation of BioSteel reporting unit as of September 30, 2022, indicated evidence of a goodwill impairment as of that date. Consequently, a goodwill impairment loss of \$57.4 million CAD was recognized, which represented the entirety of the goodwill assigned to the BioSteel reporting unit.

Redeemable Non-Controlling Interest

The BioSteel unit had redeemable non-controlling interest, which was valued based on revenue multiples. Because of the revenue-related misstatements, the company determined that the redemption value for the redeemable non-controlling interest would decline and, therefore, needed to be adjusted to a lower amount.

Impact of the Misstatements

The Company evaluated the materiality of these misstatements both qualitatively and quantitatively in accordance with SAB No. 99, *Materiality*, and SAB No. 108, *Considering the Effects of Prior Year Misstatements in Current Year Financial Statements*, and determined the effect of correcting these misstatements to be material to the Prior Financial Statements. Therefore, the prior period financial statements would need to be restated in an amended 2022 10K/A filing, which is also popularly known as a Big R restatement.

Other Adverse News in 2023 10-K

Asset Impairment and Restructuring Charges

Recognizing “unfavorable market realities” (see F-27), the company elected to close/sell some of its business units while consolidating other operations. These business decisions led to asset impairment and restructuring charges of \$2.347 million CAD. Some of the key impairment and restructuring charges were as follows.

- \$91 million CAD in impairment charges related to inventory because of the:
 - Closure of a production facility in Ontario
 - Closure of other production facilities
 - Cessation of some of the production by BioSteel
- \$42 million CAD in impairment charges related to intangible assets because of the:
 - Impairment of acquired brand intangible assets (in Canada)
- \$376 million CAD in impairment charges related to PPE
- \$1,785 million CAD in impairment charges related to goodwill because of the:
 - Impairment of goodwill associated with the Canadian cannabis operating unit
 - Impairment of goodwill associated with BioSteel operating unit

⁵ Revenue was incorrectly recognized because: (i) the product ordered by the customer had not been shipped, and therefore control of the product had not been transferred to the customer; (ii) the product was shipped without a legally enforceable written, oral or implied contract with the customer that specified each party's rights regarding the goods to be transferred and the payment terms; or (iii) product had been shipped, and ultimately not accepted by the customer, because the product did not have the required remaining shelf life to be sold through by the customer in a primary sales channel.

- Impairment of goodwill associated with This Works operating unit
- \$ 53 million CAD in restructuring charges because:
 - Contractual and settlement obligations related to closures and sales
 - Employee-related termination costs related to closures and sales
 - The total of the impairment and restructuring charges were recognized in the cost of goods sold (\$90 million CAD) and operating expenses (\$2,257 million CAD)

Auditor Report by KPMG

Going Concern

Although the consolidated financial statements were prepared assuming that the company would continue as a going concern, KPMG raised “substantial doubt” about the company’s ability to continue as a going concern because of its material debt obligations due in the short term (about \$557 million CAD) and its losses from operations.

In fact, the total amount of contractual obligations and commitments that are due within a year is \$800 million CAD (see p. 151). However, the cash balance is only \$677 million CAD, and the company does not generate any operating cash inflows.

Internal Control Over Financial Reporting

Based on audits, KPMG concluded that the company did not maintain effective internal control over financial reporting. Further, material weaknesses were identified in the following areas:

1. Ineffective control environment because of a lack of the required number of trained operational and IT personnel.
2. The material weakness in the control environment leads to misstatements in revenue and accounting receivables.

June 26, 2023 (8-K): Auditor Resignation

KPMG, which had been serving as the independent registered public accounting firm of Canopy Growth Corporation, declined to stand for reelection and resigned as the Company’s independent registered public accounting firm, effective June 22, 2023 (Portnoy, 2023).

KPMG noted that, during the fiscal years ended March 31, 2023, and March 31, 2022, and the subsequent interim period through June 22, 2023, there were no disagreements between the Company and KPMG on any matter of accounting principles or practices, financial statement disclosures, or auditing scope or procedures (2023 Proxy Statement).

Conclusions

Starting about a decade ago, Canadian cannabis companies started growing exponentially because of a presumption that the production, distribution, and consumption of cannabis would get legalized in Canada and elsewhere in the world. In Canada, this persuasion was based on the premise that the Liberal Party, led by Justin Trudeau, would legalize marijuana. Riding on generous funding from investors, Canopy Growth Corporation expanded rapidly, especially from 2018 once the company was listed on a major U.S. stock exchange. This momentum was spurred by a landmark \$5 billion CAD investment from Constellation Brands in August 2018, which to date remains one of the largest investments in a cannabis company from an external entity.

Ignoring Reality

However, as the 2022 settled class-action lawsuit finds, by 2019 the company began realizing that the cannabis market conditions had not altered sufficiently to match the aggressive growth demand projected by the management (see Ortiz vs CGC US District Court Opinion; No.2:19-cv-20543-KM-ESK). Not only did the company not disclose these revised downward projections, but the company also continued to expand by investing heavily in the cannabis market. This type of expansionary policy which often entailed paying a hefty premium for their acquisitions, without a matching increase in demand for their products, led to the eventual impairment of inventory, and the impairment of other fixed and intangible assets including goodwill. Moreover, the company was finally compelled to reverse its growth-based business strategy through divestitures and other plant closures, which hurt profitability even more because of the recognition of restructuring charges and impairment charges.

Failures

The failure of Canopy Growth Corporation can be attributed to several parties. First, management pursued an aggressive expansionary policy without admitting that their prior growth projections were unrealistic. Moreover, they failed to revise their growth forecasts downwards to reflect the changing landscape of the regulatory environment in the industry. Because the premium paid for past acquisitions was no longer justifiable under the prevailing market conditions, management also failed to warn investors about the high likelihood of future assets and/or goodwill impairments. Second, the board of directors did not provide adequate oversight of the management's operations of the company. Third, the audit committee failed to monitor the financial reporting environment effectively. Finally, auditors failed to detect material errors in the financial misstatements or monitor the effectiveness of the internal control over financial reporting. This lack of alignment between strategy, governance, and auditing led to the rapid destruction of shareholder value and the company's decline.

Future Challenges

CGC must confront numerous serious challenges. First, given that the current industry regulatory environment is unlikely to change in the near term, the company's growth in revenues is questionable. The company must improve its governance structure and internal control environment to regain trust. Additionally, if these governance and control issues are not addressed, CGC could face further regulatory scrutiny, shareholder lawsuits, and difficulty in raising capital. For the broader cannabis industry, CGC's downfall serves as a cautionary tale, highlighting the risks of aggressive expansion in a nascent, highly regulated market. Investors and regulators will likely demand stricter financial oversight, which may slow growth but could lead to more sustainable business practices over time.

Inferences

The aggressive expansionary approach in the face of unfavorable market conditions precipitated aggressive reporting and, eventually, GAAP violations. Given the impending lawsuits and the company's inability to meet its obligations in the near term, the survival of the company seems in to be serious jeopardy. The likelihood of additional future impairments and restructuring of operations seems inevitable as the company pivots to a more realistic industry environment.

The creation and eventual destruction of wealth were extraordinary. Were investors too high on hemp?

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**Table 1: High on Growth
Growth in Revenue and Earnings**

2017	2018	2019	2020	2021	2022	2023		
Revenues (in CAD\$ million)		39.9	77.9	226.3	398.8	546.6	520.3	333.3
<i>Growth in Revenues</i>			95.2%	190.5%	76.2%	37.1%	(4.8%)	(35.9%)
Net income (in CAD\$ million)		(7.5)	(70.3)	(712.0)	(1387.4)	(1670.8)	(330.6)	(3309.5)
EPS (in CAD\$)		(0.06)	(0.40)	(2.76)	(3.80)	(4.69)	(0.79)	(7.07)
<i>Growth in EPS</i>			(566.7%)	(690.0%)	(37.7%)	(23.4%)	83.2%	(794.9%)
Acquisitions								
Number of Acquisitions		2	4	8	6	0	2	1
Growth in Acquisitions			100%	100%	-25%	-100%	N/A	-50%
Total Purchase Price (CAD\$ million)		365.2	43.7	1602.1	589.7		341.1	
Total Assets (CAD\$ million)	702.7		1436.8	8731.8	6857.7	6823.5	5605.3	2439.1
Plant, Property and Equipment.		96.3	303.7	1096.3	1524.8	1074.5	942.8	499.5
Intangible Assets		162.3	101.5	519.6	476.4	308.2	252.7	188.7
<u>Goodwill</u>		<u>241.4</u>	<u>314.9</u>	<u>1544.1</u>	<u>1954.5</u>	<u>1889.4</u>	<u>1866.5</u>	<u>85.6</u>
Total		500.0	720.1	3160.0	3955.6	3272.1	3062.0	773.7

Asset Impairments (CAD\$ Million)

Plant, Property and Equipment	335.0	426.7	224.7	376.2
Intangible Assets	247.0	61.1	67.5	42.1
<u>Goodwill</u>			<u>40.7</u>	<u>1785.1</u>
Total	<u>582.0</u>	<u>487.9</u>	<u>332.9</u>	<u>2203.4</u>

Data source is: (1) Canopy Growth Corporation Form 20-F filings, based on International Financial Reporting Standards (“IFRS”) for years ended March 31, 2017, 2018, 2019, and (2) Canopy Growth Corporation Form 10-K filings, based on U.S. General Accepted Accounting Principles (“GAAP”), for years ended March 31, 2020, 2021, 2022, 2023. All numbers are in millions of Canadian dollars, except share amounts and where otherwise indicated.

Figure 1:

Panel A: CGC Stock Price from May 24, 2018 to February 28, 2022



Panel B: CGC Stock Price from March 1, 2021 to December 31, 2022

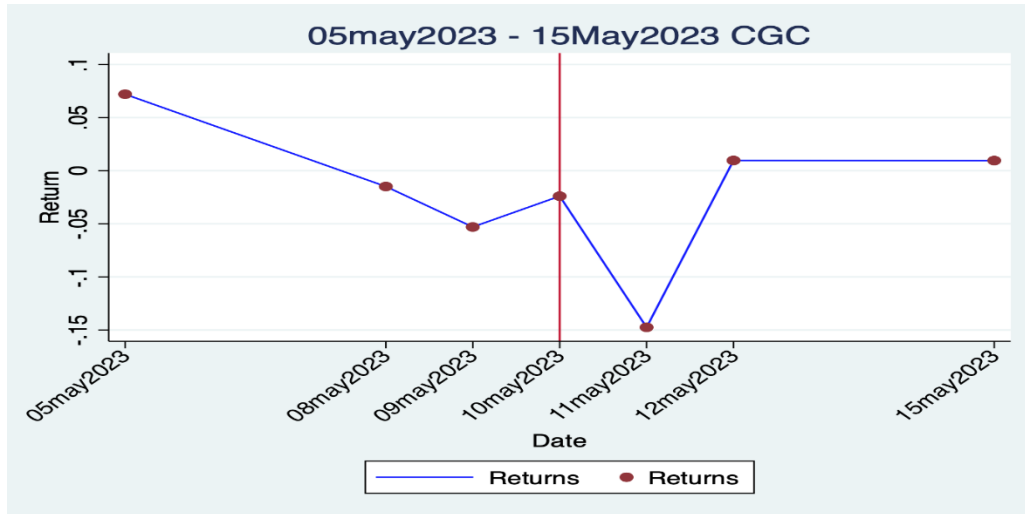


Panel C: CGC Stock Price from January 1, 2023 to July 31, 2023

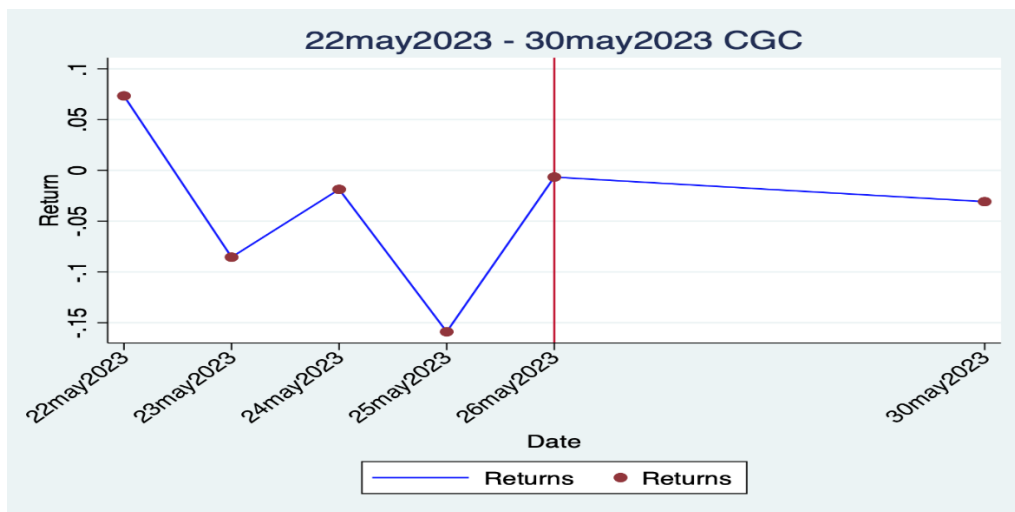


Figure 2: Event Study Analysis Around Key Dates

May 10, 2023 (8-K): Non-Reliance on Previously Issued Financial Statements or a Related Audit



May 26, 2023 (Nt 10-K): Notification of Late Filing



June 22, 2023 (10-K): Filing of the 10-K and Restatement of 2022 Financial Statements

