

# U.S. CANNABIS ACCOUNTING & FINANCIAL MANAGEMENT



**2019-2020  
BEST PRACTICES**

## EXECUTIVE SUMMARY

Sponsored by:



# executive SUMMARY

## IN 2019, THE U.S. CANNABIS INDUSTRY

continued its rapid growth and expansion. According to Gallup, a majority of the American public (66%) support full legalization of cannabis. The continued growth in public support for legalization of cannabis indicates a durable trend that will drive more states to legalize medical and adult use in the years ahead. Legal cannabis sales in the US is estimated to be \$13.6 billion in 2019, a nearly 28% increase over 2018. Sales are projected to reach nearly \$30 billion by 2025. Finally, investors channeled almost \$14 billion in capital into the industry in 2019 alone – more than the preceding three years combined, although the rate of growth in investment is slowing somewhat as the industry matures. The surging rate of investment reflects acute need among cannabis business operators for capital to build capacity and scale, and the growing recognition among investors of the industry's rich opportunities.

Despite the social momentum and surging growth of consumer demand, cannabis businesses face a complex operating environment. Due to cannabis remaining illegal under federal law, cannabis businesses are forced to operate under Internal Revenue Code (IRC) Section 280E, which prohibits businesses that profit from federally illegal substances from deducting many of the ordinary business expenses afforded to other sectors of the economy. (A notable new exception: Under the 2018 Farm Bill, hemp is no longer a Schedule I drug, so it is no longer gov-

erned by Section 280E and hemp enterprises as defined in the Farm Bill can now deduct all ordinary and necessary business expenses.) Additionally, pending reforms in federal law, cannabis businesses have limited access to capital markets as most major banks and financial institutions will not serve the industry under prohibition.

At the state level, challenges abound, from the widely varied regulations governing each state market to the inability to transport products across state lines. State-level implications of the Farm Bill and the U.S. Supreme Court decision in the *Wayfair* case have brought further complications. Additionally, as more of the state markets have grown, dramatic wholesale price declines have intensified competition and created a new imperative for efficiency and scale. As a result, M&A activity has surged as investors acquire companies across the supply chain as a way to build increased value, quickly enter new markets, neutralize competitors, or expand capabilities.

In such a turbulent environment, there are key financial issues that operators must understand to effectively and competitively operate in the industry, including:

### **All plant-touching businesses are liable for taxes under Section 280E.**

The inability to deduct anything beyond the cost of goods sold makes the impact of Section 280E more acute for retail businesses than for producers. Ancillary businesses that are not considered “plant-touching” and hemp operations are not subject to the same 280E limitations. However, distinguishing between plant-touching, ancillary, and hemp-only operations is not always clear-cut.

### **The 2017 Tax Cuts and Jobs Act afforded some breathing room to cannabis businesses.**



TO DOWNLOAD THE FULL REPORT VISIT: [NEWFRONTIERDATA.COM/ACCT2020](https://newfrontierdata.com/acct2020)

© NEW FRONTIER DATA, ALL RIGHTS RESERVED // [NEWFRONTIERDATA.COM](https://newfrontierdata.com) // 2

The TCJA introduced a 20% deduction for qualified business income that cannabis businesses can take advantage of, significantly lowering their tax liabilities.

**Lowering operational costs is not just good business, it can be a source of competitive advantage.**

In an increasingly competitive environment, it is critical that operators plan for where the industry is going, not where it currently is. For example, since the state began publishing data in 2015, prices for Colorado flower have declined 34% (roughly \$1,300 per pound) recovering from a low of \$759 (-63%) in October of 2018. The steep decline and sharp swings have put intense pressure on less-efficient growers as their margins have fluctuated and made it difficult to forecast revenues. Comparatively, growers who have been focused on maximizing efficiency and minimizing costs have been able to thrive despite the sector's turbulent economics. While the impact of competition and price declines is being felt most acutely among producers, other businesses in the cannabis supply chain should anticipate and prepare for similarly intense competition and disruptive market dynamics in the foreseeable future.

**Cost-segregation studies offer an effective way to minimize tax liabilities.**

With the huge tax bill that accompanies Section 280E, it is imperative that cannabis businesses find as many means as possible to lower their tax burdens. Cost-segregation studies – which entail a systematic review of depreciable assets to identify which qualify for a shorter depreciable life than the standard 39 years for buildings and the 39 years for qualified improvement

properties (pending an IRS technical correction) – can help significantly lower an operator's tax burden. Additionally, the tax savings from the CSS can range from 10x to 30x the cost of doing the study, granting a high return on investment.

**Operating a cash-based cannabis business creates additional complexity, and security risks.**

With the industry on track to generate \$17 billion in revenue in 2020, most of which is in small dollar transactions, cannabis businesses are awash with cash yet have few places to put it. Beyond the considerable security and accounting issues created by having such high volumes of cash cycling through their operations, cannabis businesses must ensure that they have robust internal monitoring and control processes, and that they are compliant with the U.S. Treasury and IRS's cash payment reporting requirements, as failure to do so could result in significant penalties.

**As company valuations rise, thorough due diligence becomes ever more important.**

With well-capitalized operators and investors deploying large sums of capital into the market, strategically placed companies are seeing their valuations rise dramatically. During this increasingly frenzied period of M&A activity, it is vitally important for acquirers to thoroughly vet any potential targets, and ensure that there is a clear understanding of any potential liabilities that might accompany the deal. Failing to properly understand the acquisition target can be extremely costly, and can expose the purchasing company to significant legal risk.

**Cannabis real estate is booming, but it is not without risks.**

Real estate has been one sector of the industry that has sustained strong growth. In most jurisdictions, there are only a limited number of properties appropriately zoned or well suited for a cannabis operation, making them especially attractive to cannabis investors. However, long-term cannabis real-estate investors should consider the potential disruptions to the current industry based on full national legalization and the advent of interstate commerce. Additionally, with energy costs being one of the largest production costs, many growers are turning to greenhouses for alternative cultivation environments. Such changes



will drive production and processing from high-cost to low-cost areas of the country, and from indoor facilities to mix-light and outdoor grows. Consequently, the demand for indoor cultivation space may decline in the medium term, following this initial period of strong growth.

**Businesses should prepare emergency response and continuity of operations protocols to minimize disruptions.**

The early stages of the coronavirus emergency have highlighted the importance of disaster planning and emergency preparedness. Amidst heightened risks of environmental disruptions, businesses should be prepared for the inability of key employees to get to work, major disruptions to supply chains for critical operational inputs, and catastrophic natural phenomena, including climate-change-related weather events, fires, and earthquakes. Contingency considerations should prioritize employee safety, security of business assets, and minimization of disruptions to business operations.

**Technology is playing a greater role in operationalizing, diversifying, and regulating the industry, and can be a source of competitive advantage.**

The requirement that cannabis businesses track their products from seed to sale forced a complex reporting requirement on the industry that technology has worked to fill. But beyond tracking products across the supply chain, technology-driven innovation is transforming almost every aspect of the industry, from cultivation technologies optimizing the grow environment to web-enabled consumer devices that provide detailed customization and dosing tracking.

Across these applications, technology can play a key role in building competitive advantage, whether through making operations more efficient, enabling the development of new products and services, or providing data to drive sharper, more agile decision-making.

**With international markets quickly opening, this is the dawn of a global cannabis industry.**

The global landscape for cannabis is changing quickly, with Canada becoming the first developed nation to fully legalize cannabis, and a host of countries around the world exploring new laws for medical or adult use. Luxembourg is on track to be the first European country to fully legalize and regulate cannabis. Mexico is poised to be the first country to legalize and regulate cannabis following a court decree, after the country's Supreme Court declared cannabis prohibition unconstitutional. And in February 2020, Malawi became the latest African country to legalize medical cannabis and industrial hemp, following southern African neighbors Lesotho, Swaziland, Zambia, and Zimbabwe. Further, established markets including Germany, Canada, and Colombia continue to gain traction amid an increasing number of licensed businesses, improved product access for consumers, and rising patient registrations.

While it may be some time until American companies can participate in the global cannabis economy, businesses looking to expand internationally should begin planning early for the best-suited business structures (and accounting practices) to do so.

The cannabis industry's growth makes it a highly attractive sector for investment. However, the federal illegality of cannabis and the patchwork of state laws make it a uniquely challenging industry in which to operate. For participants in this market, both an intimate understanding of the unique rules that govern plant-touching businesses and the deployment of strategic financial management and accounting best practices are keys to ensuring compliance with federal and state laws, and can be sources of differential advantage in an increasingly competitive market. This report introduces some of the key themes that cannabis investors and operators must consider as they plan, grow, and compete in this opportunity-rich but high-risk environment.



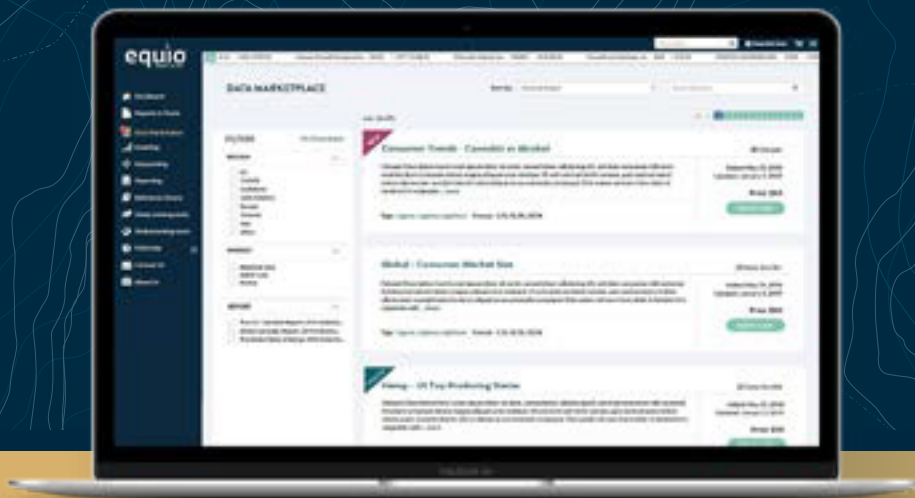
# CANNABIS DATA AT YOUR FINGERTIPS

Introducing Equio's Data Marketplace

Consumer Trends Data

Global Market Data

Hemp Data



**equio**<sup>®</sup>  
CANNABIS BUSINESS INTELLIGENCE PORTAL

**CONQUER**  
THE WILD

Learn more at: [Equio.solutions](https://Equio.solutions)  
or email us at: [Sales@NewFrontierData.com](mailto:Sales@NewFrontierData.com)

New  
**Frontier**<sup>®</sup>  
data





# ARE YOU READY?

Your business has a vision. And every decision... every deal... can get you closer.

Serving both plant and non-plant touching companies, CohnReznick's cannabis industry professionals help you drive growth and protect assets through a range of operational, financial, tax, and compliance solutions.

Our partner-led teams bring deep technical knowledge— along with extensive experience in emerging markets— to move your business ahead with insight and confidence.

**Are you ready to achieve your vision?  
Let's get going.**

**Visit us at [cohnreznick.com/cannabis](https://cohnreznick.com/cannabis)**

Copyright © 2020 by Frontier Financial Group, Inc., dba/ New Frontier Data. All rights reserved. Photocopying or reproducing this report in any form, including electronic or facsimile transmission, scanning or electronic storage, is a violation of federal copyright law and is strictly prohibited without the publisher's express written permission.

This report may not be resold. New Frontier Data only sells its publication directly or through authorized resellers. Information concerning authorized resellers may be obtained from New Frontier Data, 1990 M Street, NW Suite 530 Washington DC 20036.

While every effort has been made by New Frontier Data, Inc. to ensure the accuracy of information in this report, it accepts no responsibility for errors or omissions. The report is sold as is, without warranty of any kind, either express or implied, respecting its contents, including but not limited to implied warranties for the report's quality, performance, merchantability, or fitness for any particular purpose. Neither New Frontier Data nor its dealers or distributors shall be liable to the purchaser or any other person or entity with respect to any liability, loss, or damage caused or alleged to be caused directly or indirectly by this report.

CohnReznick LLP © 2020

This has been prepared for informational purposes, is general guidance only and does not constitute legal or professional advice. You should not act upon the information contained in this publication without first obtaining professional advice specific to, among other things, your individual facts, circumstances and jurisdiction. No representation or warranty (express or implied) is made as to the accuracy or completeness of the information contained in this publication, and CohnReznick LLP, its partners, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.



# NEW FRONTIER DATA

## HEADQUARTERS

1400 I Street NW / Suite 350 / Washington, DC 20005

## SALES & MARKETING

535 16th Street / Suite 620 / Denver, CO 80202

## LONDON

Smith Building / 179 Great Portland Street / London W1W 5PL

✉ [info@NewFrontierData.com](mailto:info@NewFrontierData.com) ☎ 844-420-D8TA

@NewFrontierData



[NewFrontierData.com](http://NewFrontierData.com)

[InterCannAlliance.com](http://InterCannAlliance.com)

[HempBizJournal.com](http://HempBizJournal.com)



Strength in Knowledge®