

MJ Business

<https://mjbizdaily.com/how-accounting-practices-can-impact-cannabis-industry-deals/>

How accounting practices can impact cannabis industry deals

MJBiz

By **Kellan McConnell**

November 16, 2021



(Editor's note: This story is part of a recurring series of commentaries from professionals connected to the cannabis industry. Kellan McConnell is an audit partner in Marcum's Costa Mesa, California, office.)

As the cannabis industry has begun to mature, there has been a surge in mergers and acquisitions, joint ventures, partnerships and other combinations.

Unfortunately, many deals are being held up by incomplete and/or inaccurate financial statements.

Failure to have the accounting processes and procedures in place necessary to accurately and timely capture all of a company's operations on a day-to-day basis causes delays in closing deals or, in many cases, precludes deals from happening at all.

One of our cannabis clients, for example, has a large deal waiting to be executed, but the 2019 and 2020 audits need to be completed before the acquirer will sign off.

We weren't engaged until September 2020 for the 2019 financials, and that work is still ongoing, mainly because of poor recordkeeping and the lack of a consistent and competent accounting function at the company.

It's costing time and money, and the CEO can't execute on his vision because he's stuck in the mud.

Cannabis CEOs must prioritize the accounting/finance function by allocating resources to build a competent internal accounting team, hire external consultants or a combination of the two in order to establish sound SOPs (standard operating procedures).

In turn, this will allow them to present accurate and timely financial information in any type of deal situation.

While it takes time and money to bring financial reporting up to the level of quality that can withstand the scrutiny of an audit, having the books and records clean, audited and available to use in any type of deal scenario can mean the difference between closing a deal and missing out.

Following are some of the most important areas companies should be focusing on:

Cash management

Under their federal charters, many financial institutions are unable to accept dollars earned in the cannabis industry, and many of these same banks have begun closing the accounts of long-time customers who have chosen to get involved in this industry.

It is essential to have a relationship with a financial institution that welcomes deposits from cannabis operators and is making loans to clients in the industry, once they have cleared important banking due diligence requirements.

State-chartered and community banks, as well as non-federal credit unions, are among the institutions that can conduct business with cannabis industry participants.

Inventory management

Even as the cannabis industry accelerates, there remains tremendous uncertainty in the marketplace and changing rules at every level – state, county and municipal.

Every state that permits cannabis operators has ultrastrict guidelines to monitor the operation “from seed to sale” and at each mile marker along the way.

Operations require comprehensive systems that allow growers, distributors, retailers and others to account for revenues and expenses, in addition to the product itself.

While state-mandated controls help, companies should have additional robust inventory-management SOPs that include regular physical inventory counts.

Related-party transactions

Many cannabis companies have extremely complex entity organization charts.

There can be VIEs (variable interest entities), joint ventures and direct investments.

We also see all sorts of services and management agreements between entities with common control.

It can be complicated to keep these relationships straight, and the facts and circumstances change rapidly, which can change the related accounting under generally accepted accounting principles (GAAP).

Recordkeeping

A company's financial reporting is only as good as the data it collects and retains.

This is especially so for cannabis companies, which conduct many transactions in cash.

Initial audits can be extremely difficult, if not impossible, if the company does not retain complete transaction records.

Capital

Capital is the lifeblood of any business.

It is imperative that your entity is well-capitalized in order to withstand the peaks and valleys that can disrupt the normal flow of operations and any downturn in the economy or industry.

Being undercapitalized will jeopardize your ability to survive any of these scenarios.

Being overcapitalized means that your dollars are not being maximized.

Relationships with investors unencumbered by underwriting requirements is essential to cannabis enterprises in need of capital.

Cash flow

One of the most important parts of any business plan is the preparation of forecasts and projections.

A forecast is what is likely to happen, whereas a projection is a likely outcome, based on a certain set of assumptions.

Your team should have the experience of helping startup entities and emerging growth companies prepare comprehensive and accurate projections utilized by management to monitor future results.

They should understand the nuances of operating in the cannabis industry, including restrictions on the deductibility of expenses under [Section 280E](#) of the U.S. tax code.

Items typically standard as cost of goods sold will be subject to IRS scrutiny, such as employee salaries, utilities, marketing and advertising, routine repairs and maintenance, rent, insurance and payments to contractors.

Anti-money laundering

In addition to knowing your customer, which is required by all financial institutions, any entity doing business in the cannabis space is required to meet certain anti-money-laundering criteria, including but not limited to:

- Accounting for cash deposits.

- Having a record of customers.
- Tracking mass shipments to suppliers.
- Maintaining a record of any red flags that might occur during a business' normal course of operations.

Security

Cannabis companies are required to have extensive security procedures relating to:

- Background checks for all current and future employees, board members and other stakeholders.
- Safeguards against theft.
- Procedures to monitor the production and sale of product.

Industry operators must be prepared to develop, implement and annually document all security measures, including video surveillance, record maintenance and a host of others.

The regulations are complex and continuously changing, with states promulgating new rules on an ongoing basis.

Taxes

Under Section 280E of the tax code, “No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by federal law or the law of any state in which such trade or business is conducted.”

This section has a dramatic impact on the taxability of net income and the ultimate profit generated by cannabis entities.

In addition, tax planning for business expenses must take into account each of a company's separate businesses, strategies to maximize the cost of goods sold as well as the administration of taxes other than those for income (sales, excise, cultivation, etc.).

Both operating cannabis businesses and those planning to enter and succeed within this emerging industry need the right support, objectivity and market experience to ensure their accounting and financial reporting systems are optimized.

Whether you choose to build a competent internal accounting team, hire external consultants – or a combination of both – the ability to present accurate and timely financial information is mission critical to getting deals done.

Kellan McConnell can be reached at kellan.mcconnell@marcumllp.com.