

Audit of the City's Medical Marijuana Dispensaries

Report # 2017-06 | October 2017

The Revenue Division Could Improve Its Monitoring of the Business Operations Tax (BOT) Collection Process to Better Detect Underreporting

Medical Marijuana Dispensaries Are Not Complying with the City's Operating Requirements

The Revenue Division Could Benefit from Improved Recordkeeping and More Thorough Reviews of Dispensary Permit Applications



City of
SACRAMENTO
Office of the City Auditor

Jorge Oseguera, City Auditor
Lynn Bashaw, Assistant City Auditor
Chau Cao, Senior Auditor



The City of Sacramento's Office of the City Auditor can be contacted by phone at 916-808-7270 or at the address below:

915 I Street
MC09100
Historic City Hall, Floor 2
Sacramento, CA 95814

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RECOMMENDATIONS

We made several recommendations aimed at strengthening monitoring of medical marijuana dispensary BOT payments, improving compliance with City Code, and enhancing recordkeeping. Our recommendations include:

Strengthen Monitoring

- Determine why dispensaries failed to produce the requested financial documentation and consider imposing penalties to encourage compliance with document requests.
- Develop a robust review process of the dispensaries' financial statements during the permit renewal process to identify potential underreporting of gross receipts.
- Perform observation tests of dispensaries to identify underreporting of gross receipts and consider collecting monies owed.
- Develop controls to ensure dispensaries' gross receipts are recorded monthly and reconcile payments.
- Implement controls to ensure complete reviews of MuniServices' audit reports and follow up on audit findings.
- Reevaluate the frequency of MuniServices audits to ensure timely coverage.

Improve Compliance

- Assess the hours spent on dispensary inspections to determine whether CDD has adequate or excess resources.
- Develop a risk-based enforcement program that identifies high risk violations and implement a follow-up process to ensure violations are resolved in a timely manner.
- Consider imposing penalties to encourage timely compliance with City Code.
- Engage the Office of the City Auditor to perform inspections at the *All About Wellness* dispensary to assess whether the dispensary is complying with City Code and State laws.
- Reevaluate the language in the City Code, and if necessary, strengthen the Code to make it clear that the City has the legal right to enter and inspect dispensaries' property and financial records.
- Review and update the dispensaries operating requirements to ensure consistent enforcement practices.
- Reevaluate and clarify City Code regarding the timeframe associated with discontinuance of use.
- Follow up on *Community Health Solutions* to determine if the dispensary is operating.

Enhance Document Retention

- Strengthen controls over the permit renewal application approval process to ensure that all required documentation is obtained and retained.
- Define and communicate to the dispensaries the documents needed to substantiate changes.

Audit of the City's Medical Marijuana Dispensaries

October 2017

2017-06

BACKGROUND

The City of Sacramento has permitted 30 medical marijuana dispensaries to provide medical marijuana to their members. There is currently a moratorium on new permit applications and existing dispensaries must renew their permits annually in order to continue operating.

Medical marijuana dispensaries are subject to a four percent BOT on their gross receipts that is remitted to the City monthly. Annual BOT revenue remitted to the City has grown steadily since inception, exceeding \$4.5 million in calendar year 2016.

FINDINGS

The Revenue Division Could Improve Its Monitoring of the BOT Collection Process to Better Detect Underreporting. More specifically, we found:

- Dispensaries did not provide financial and membership documentation;
- Underreporting of BOT may be discovered by reviewing financial statements and tax returns;
- Dispensaries may be underreporting gross receipts;
- The Revenue Division should improve oversight of the BOT program;
- MuniServices' audit findings were not sufficiently addressed; and
- The frequency of audits should be reevaluated to ensure timely coverage of all dispensaries.

Medical Marijuana Dispensaries Are Not Complying with the City's Operating Requirements:

- The site inspection process is not comprehensive and failed to identify instances of non-compliance;
- One dispensary refused to grant the Office of the City Auditor access to the dispensary;
- Not all dispensaries are subject to the same operating requirements; and
- One dispensary may no longer be operational.

The Revenue Division Could Benefit from Improved Recordkeeping and More Thorough Reviews of Dispensary Permit Applications:

- The Revenue Division's review process lacks controls to ensure compliance with permit application requirements; and
- The Revenue Division could better document dispensary managing member, location, and entity name changes.

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Introduction

In accordance with the City Auditor's 2016/17 Audit Plan, we have completed an *Audit of the City's Medical Marijuana Dispensaries*. We conducted this performance audit in accordance with Generally Accepted Government Auditing Standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The Office of the City Auditor would like to thank the Revenue Division, Community Development Department, Police Department, and the Office of the City Attorney for their time and cooperation during the audit process.

Background

City Code Chapter 5.150 stated that, "[in] 1996 California voters approved Proposition 215, entitled 'The Compassionate Use Act,' that was later codified at Health and Safety Code Section 11362.5. The Compassionate Use Act ensures that qualified patients and their primary caregivers who obtain and use marijuana for medical purposes upon the recommendation of a physician are not subject to criminal prosecution or sanction under state law. In 2003 the state enacted Senate Bill 420, known as the Medical Marijuana Program, codified at Health and Safety Code Section 11362.7 et seq. The Medical Marijuana Program was intended to supplement the provisions, and clarify the intent, of the Compassionate Use Act and to allow cities to adopt and enforce rules and regulations consistent with the Medical Marijuana Program." Under the program, "medical marijuana patients and primary caregivers may associate within the State of California in order collectively or cooperatively to cultivate marijuana for medical purposes." To prevent diversion of medical marijuana to non-medical markets, collectives and cooperatives should only acquire and distribute medical marijuana to members.

Moratorium on New Medical Marijuana Dispensaries

Enacted July 14, 2009, City Ordinance 2009-033 established a moratorium on new medical marijuana dispensaries within the City of Sacramento. The purpose of this ordinance was to "protect the public health, safety, and welfare by prohibiting the establishment of new medical marijuana dispensaries or expansion or modification of established medical marijuana dispensaries while the City studies and enacts new land use conditions and regulations..." Existing medical marijuana operations were exempt from the moratorium if they submitted applications to register as an "established operation" within 30 days of the ordinance and provided credible evidence that they had been in operation since at least June 16, 2009, in a manner consistent with the requirements of the Compassionate Use Act and the Medical Marijuana Program. The moratorium remains in effect and the City is not accepting new applications for medical marijuana dispensaries.

Medical Marijuana Dispensary Permit

On November 9, 2010, the City Council adopted Ordinance 2010-37 and added Chapter 5.150 to Title 5 of the Sacramento City Code to regulate the medical marijuana dispensaries. The City Code Chapter

5.150 *Medical Marijuana Dispensaries* stated that “it is the purpose and intent of the city council to regulate medical marijuana dispensaries consistent with the Medical Marijuana Program and to protect the health, safety, and welfare of the residents of the city.” This section of City Code outlined the requirements for medical marijuana dispensaries to obtain a dispensary permit and stipulates their operating requirements in the City of Sacramento. Only registered medical marijuana dispensaries could proceed with two additional phases of the application process to obtain the medical marijuana dispensary permit.

Phase one applications had to be filed with the City by February 7, 2011. The phase one application required general information related to the dispensary, such as the identity of dispensary, management information, criminal background of applicant and management member(s), dispensary description, and compliance with applicable taxes. In addition, the application required a description of the dispensary’s operating plans for ensuring that medical marijuana is not purchased or sold in a manner that would generate profit, that medical marijuana is distributed only to members, and that access to dispensaries is adequately monitored and restricted to members.

After the City’s adoption of dispensary regulations, federal prosecutors in the State issued statements indicating that those engaged in the marijuana business and even public officials and employees may be subject to prosecution. In October of 2011, the California Court of Appeal published its decision in *Pack v. Superior Court* which held that municipal regulation and permitting of medical marijuana dispensaries is preempted by federal law (the opinion would later be depublished). These events not only threatened the people engaged in the industry and the officials and employees engaged in administering the City’s regulations, but it also called in question the viability of the entire program. The next month, the City suspended the processing of phase two applications due to uncertainty over federal marijuana laws. The suspension allowed the City additional time to explore alternatives and consider changes to the medical marijuana program. During this time, the U.S. Attorney’s Office commenced enforcement against property owners of medical marijuana dispensaries which included criminal or civil sanctions and/or forfeiture of property. In May of 2013, the California Supreme Court published its landmark decision in *City of Riverside v. Inland Empire Patients Health and Wellness Center, Inc.* which held that State law did not preempt local ordinances banning medical marijuana dispensaries. In August of 2013, almost two years after the City suspended its medical marijuana program, the United States Attorney General’s Office issued a memo stating that it would not focus federal enforcement efforts on marijuana-related activity in jurisdictions that have strong and effective regulatory enforcement systems to control it. In the Fall of 2013, the City lifted its suspension of its medical marijuana program and resumed the permitting process.

Phase two applications had to be filed with the City by March 31, 2014. The phase two application included more detailed information, such as the dispensary’s security plan, floor plan, site plan, accessibility evaluation, neighborhood context map, lighting plan, insurance policy, annual budget for operations, recent year’s financial statement and tax return, and a list of prices for products and services provided by the dispensary. Approved phase two applicants were granted the medical marijuana dispensary permit to legally operate in the City.

The City imposed fees to recover costs associated with regulating the medical marijuana program such as processing applications and providing proactive enforcement of City Codes. The fees funded additional field and administrative staff to implement and enforce the medical marijuana program. The figure below shows the fees associated with obtaining a medical marijuana dispensary permit.

Figure 1: Fees Associated with a Medical Marijuana Dispensary Permit

Medical Marijuana Dispensary Permit Description	Fee Amount
Dispensary Permit Application	\$5,000
Dispensary Permit Program	\$12,600
Dispensary Permit Program Appeal, if applicable	\$400

Source: Auditor generated based on Resolution No. 2010-644.

A medical marijuana dispensary permit expires one year after its issue date and may be renewed by filing an application for renewal along with applicable fees and documentation. City Code specifies that “[a] dispensary permit may not be transferred, sold, assigned, or bequeathed to another person.” Any attempt to transfer a dispensary permit or relocate without filing a relocation application will result in revocation of the permit.

Conditional Use Permit

On November 9, 2010, the City Council adopted Ordinance 2010-38 and added conditional use permit (CUP) requirements for dispensaries to Title 17 Planning and Development Code. In addition to the dispensary permit, a medical marijuana dispensary must also obtain a CUP that governs the dispensary location and the operating standards of the dispensary. The location requirements established the minimum distance that a dispensary can be located to a school, residential zone, church, or child-care facility. In addition, the City may impose additional conditions to a CUP such as retail sales hours and security protocols to deter crime and protect the safety and welfare of the dispensaries and their surrounding neighborhood. Registered medical marijuana dispensaries that requested CUPs before October 26, 2010 and had not subsequently operated at another location were exempt from the City’s location requirements. The CUP may be denied if the dispensary is found to generate an excessive number of calls for police service or cause secondary criminal or public nuisances.

The City imposed fees to recover costs associated with processing CUPs for medical marijuana dispensaries. The fees provided funding for research, community outreach, and administrative support. Fees listed are initial filing fees and applicants may pay additional fees if the actual cost of processing an application exceeds amounts listed. Once the CUP is approved, no new fee is required if the dispensary remains in the same location. Figure 2 shows the fees associated with obtaining a CUP for medical marijuana dispensary.

Figure 2: Initial Filing Fees Associated with a CUP

CUP Description	Fee Amount
Planning Commission Special Permit	\$19,415
Zoning Administrator Special Permit	\$13,815
Zoning Administrator Major Modification, if applicable	\$3,500

Source: Auditor generated based on Resolution No. 2010-645.

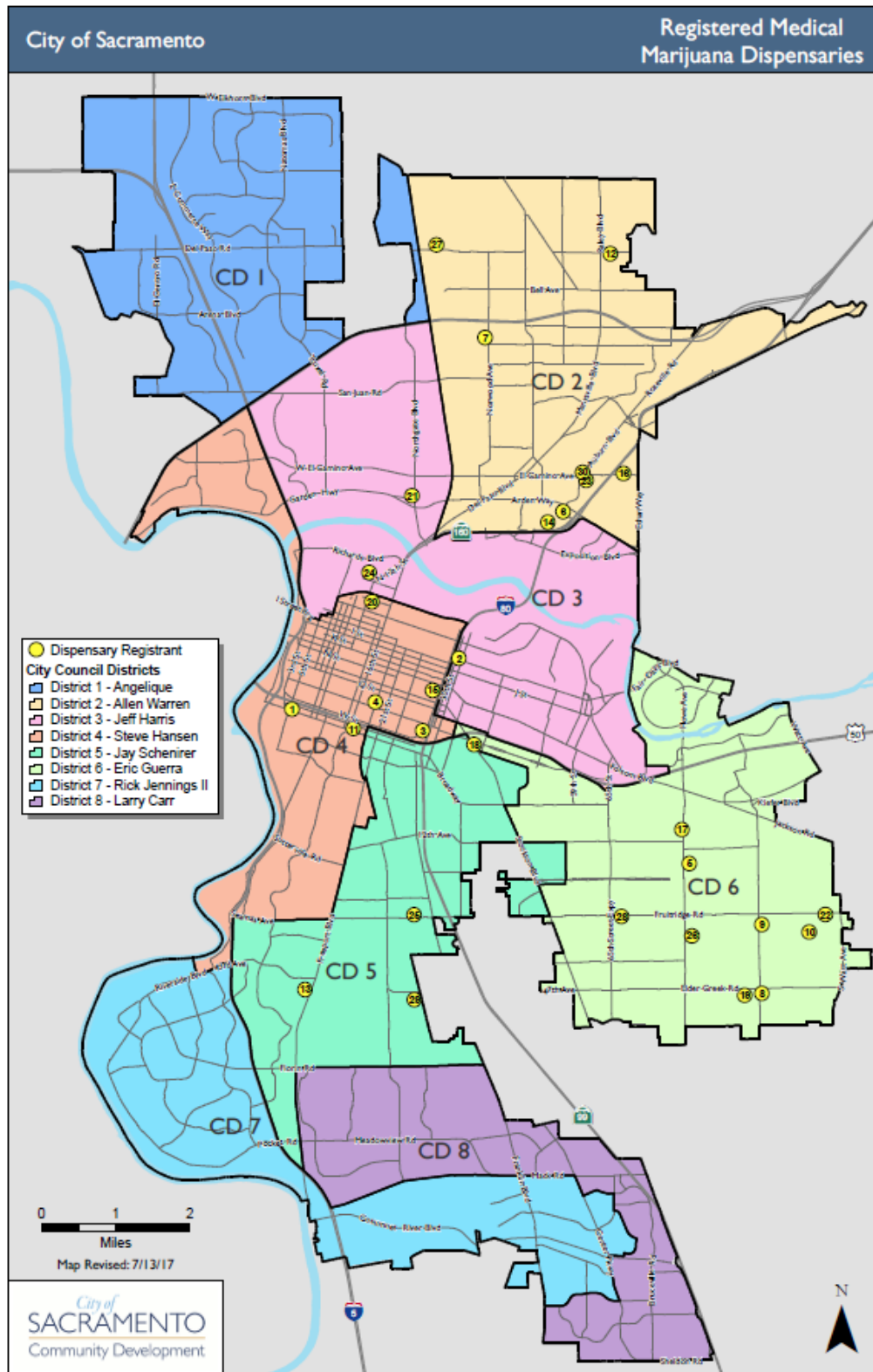
Business Operations Tax

On November 2, 2010, Measure C was passed by Sacramento voters and amended the City's existing business operations tax (BOT) to set new tax rates for marijuana businesses. The marijuana business tax rate was set at a maximum of four percent of the marijuana business' annual gross receipts and took effect on July 1, 2011. Gross receipts are identified as the total amount received from all sales excluding discounts and applicable taxes. The language from Measure C was later codified in Sacramento City Code Chapter 3.08, *Business Operations Tax*, which requires marijuana businesses to remit "four percent of each dollar of gross receipts for the reporting period" each month.

Dispensary Locations

In May 2015, the City finalized its review of dispensary applications and issued medical marijuana permits to 30 dispensaries. The names and locations of the dispensaries are depicted in the figures below, in alphabetical order.

Figure 3: Map of Dispensary Locations as of January 2017



Source: Generated by the Information Technology Department.

Figure 4: Dispensary Names

1. 515 Broadway	16. Greenstone Biomass P.O.D.
2. A Therapeutic Alternative	17. Horizon Nonprofit Collective
3. Abatin Wellness Center of Sacramento	18. Hugs Alternative Care
4. All About Wellness	19. Metro Health Systems, Inc.
5. Alpine Alternative	20. Northstar Holistic Collective
6. Alternative Medical Care	21. P.S.A.C. Inc.
7. Canna Care Inc.	22. PERCHTA
8. CC101	23. River City Phoenix
9. Cloud 9	24. Roseville Gold Inc.
10. Community Health Solutions	25. Sacramento Community Cannabis Collective (SCCC)
11. Delta Health and Wellness	26. Safe Accessible Solutions
12. Doctor's Orders	27. Safe Capitol Compassion
13. Florin Wellness Center Inc.	28. Sharp Source
14. Golden Health & Wellness	29. South Sacramento Care Center
15. Green Solutions	30. Valley Health Options

Source: Auditor generated based on BizLINK data.

Monitoring, Enforcement, and Oversight of Medical Marijuana Dispensaries

The Revenue Division of the City's Finance Department administers the medical marijuana dispensary program by granting dispensary permits, collecting BOT, and managing a contractor that performs financial audits of the dispensaries. MuniServices, LLC has been performing revenue audits for the City since 2002. In July 2014, MuniServices' contract included audits of the medical marijuana dispensaries. The City's Revenue Division randomly selects five dispensaries annually and directs MuniServices to audit the selected dispensaries. As of July 2017, MuniServices has concluded audits of 10 medical marijuana dispensaries and was conducting audits of five additional dispensaries. Results of the medical marijuana dispensary audits are submitted to the Revenue Division for review and enforcement of audit findings. As of July 2017, MuniServices identified a total of \$139,211.84 in BOT underpayment.

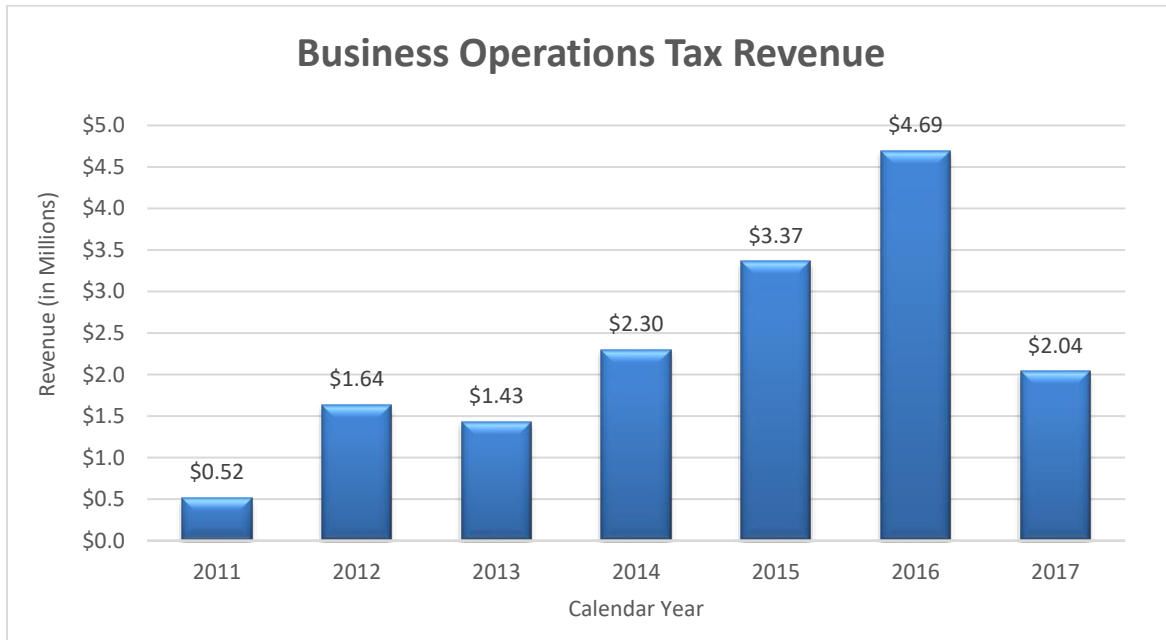
In addition to the financial audits, dispensaries are regulated and monitored by the Community Development Department (CDD) by means of unannounced site inspections. CDD inspections are performed to help ensure that dispensaries are meeting CUP conditions of approval and some operating requirements. The Revenue Division requests CDD identify inspection issues as part of the annual medical marijuana dispensary permit renewal process.

In April 2017, the City established the Office of Marijuana Policy & Enforcement as one of the resources to address illegal marijuana businesses and regulate the local marijuana industry. The Office of Marijuana Policy & Enforcement is a subdivision of the City's Finance Department and is currently responsible for developing marijuana policy.

Medical Marijuana Dispensary Tax Revenue

Medical marijuana dispensary BOT revenues are deposited into the City's General Fund. BizLINK is the software system used to track the dispensaries' reported gross receipts and the BOT payments made to the City. The figure below shows the total BOT revenue remitted by dispensaries since July 2011, by calendar year. Federal enforcement caused several dispensaries to close and may have contributed to the decrease in revenue from 2012 to 2013. The medical marijuana dispensary tax revenue increased year over year between 2013 to 2016 and is projected to increase further in 2017.

Figure 5: Business Operation Tax Revenue by Calendar Year

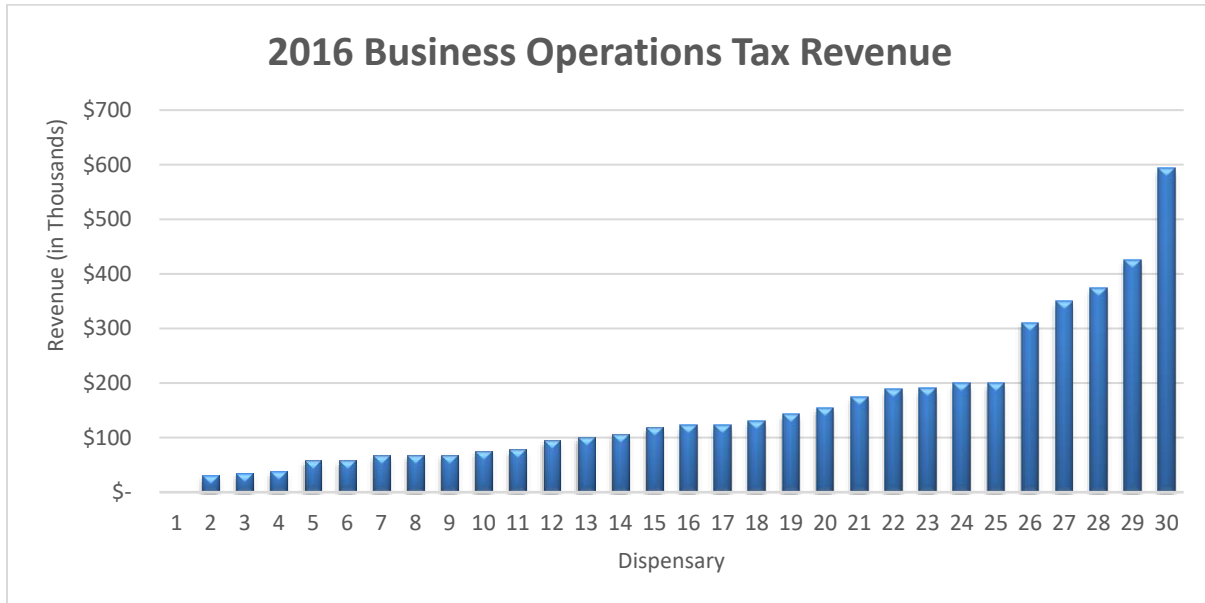


Note: 2011 data is a partial year (July to December) and 2017 data is a partial year (January to May).

Source: Auditor generated using BizLINK data from July 1, 2011 to May 31, 2017.

Medical marijuana dispensaries vary in size as well as sales volume. The figure below shows the BOT revenue collected from the dispensaries in the order of lowest to highest revenue.

Figure 6: Sum of BOT Remittance by Dispensary



Note: The dispensary numbers do not correlate to Figure 5.

Source: Auditor generated using BizLINK data from January 1, 2016 to December 31, 2016.

The medical marijuana dispensary permit fees are used to fund three City staff who monitor and enforce the medical marijuana program. Fees collected are split between the Revenue Division (40 percent), to fund a Program Analyst, and the CDD (60 percent) to fund a Zoning Investigator and a Customer Service Representative.

Objective, Scope, and Methodology

Our objective of the *Audit of the City's Medical Marijuana Dispensaries* was to assess the controls surrounding the operations of the dispensaries and to identify areas of risk and opportunities for improvement. The scope of our audit included a review of the medical marijuana dispensary permit applications and BOT records. To gain an understanding of the monitoring and enforcement efforts of the medical marijuana dispensaries, we also reviewed site inspection data. We performed on-site observations of some dispensaries to assess the accuracy of BOT remittance and to identify compliance with City Code and applicable State laws and regulations. We reviewed best practices, State laws and regulations, interviewed staff, and performed analysis and testing of dispensary data. Our tests of randomly and judgmentally selected samples were designed to provide reasonable assurance to identify areas of risk and were not intended to be representative of the whole population.

Our ability to fully execute the intended audit program was hindered as one owner would not allow us to enter the dispensary and did not provide us with key pieces of information. Furthermore, we also experienced a lack of cooperation by some of the dispensaries to provide access to membership records and financial documents. As a result, we were unable to fully assess the accuracy of BOT remittance and perform testing related to financial statements. Due to dispensaries failing to provide key membership and sales information, we were unable to perform any testing to determine if dispensaries were purchasing from or distributing to non-members.

Our audit procedures were performed using the best available information. The Revenue Division maintains hard copies and electronic copies of medical marijuana applications; however, the files may not be complete due to potential misfiling and loss of documents. Additionally, the Revenue Division experienced a change in staffing of the Project Analyst position assigned to oversee the medical marijuana program in June 2013; thus, historic knowledge of the program may not be complete. Although our testing identified concerns with incomplete and inaccurate data, we relied on BizLINK and the Revenue Division's records as they were the best information available.

Finding 1: The Revenue Division Could Improve Its Monitoring of the Business Operations Tax (BOT) Collection Process to Better Detect Underreporting

Due to strict federal guidelines, medical marijuana dispensaries have limited access to banking services and, as a result, are cash-based businesses. According to the Internal Revenue Service (IRS), “cash transactions are anonymous, leaving no trail to connect the purchaser to the seller, which may lead some individuals to believe that cash receipts can be unreported and escape detection.” The cash-intensive nature of marijuana dispensaries may increase the risk of underreporting sales and, in turn, underpayment of taxes. Additionally, various studies performed by the IRS and the General Accounting Office, a government agency that investigates how the federal government spends taxpayer dollars, indicate that there is an increase in underreporting of income for taxpayers with the ability to self-report income. Businesses have an incentive to underreport sales as doing so may reduce their tax liability; therefore, it is important to have mechanisms to identify and discourage intentional underreporting. To ensure the collection of proper tax revenue, the IRS established penalties to encourage compliance. The IRS stated that penalties encourage voluntary compliance by demonstrating the fairness of the tax system to compliant tax payers and by increasing the cost of non-compliance. For example, the IRS established penalties for taxpayers that filed incorrect information or failed to furnish required tax statements.

As mentioned previously, the City imposes a four-percent BOT on a dispensary’s gross receipts. In reviewing the BOT collection process, we found that the City’s Revenue Division had not fully addressed the risks associated with the cash-intensive nature of medical marijuana dispensaries. Specifically, we found:

- Dispensaries did not provide financial and membership documentation;
- Underreporting of BOT may be discovered by reviewing financial statements and tax returns;
- Dispensaries may be underreporting gross receipts;
- The Revenue Division should improve oversight of the BOT program;
- MuniServices’ audit findings were not sufficiently addressed; and
- The frequency of audits should be reevaluated to ensure timely coverage of all dispensaries.

It is essential that the City have adequate controls in place to ensure proper reporting and remittance of taxes. The current BOT collection process relies on the dispensaries to self-report their gross receipts, and in turn, self-declare how much BOT to remit to the City. At the same time, the City is not provided with the financial documents needed to reconcile the dispensaries’ gross receipts to the payments data to ensure payments received are complete and accurate. This BOT collection process leaves the City at a disadvantage because it must rely on the dispensaries’ voluntary compliance in accurately reporting and remitting BOT payments.

The City should consider implementing a comprehensive BOT review for all dispensaries that includes more frequent auditing and oversight to prevent or detect underreporting in a more timely manner.

Dispensaries Did Not Provide Financial and Membership Documentation

According to the IRS' *Cash Intensive Business - Audit Techniques*¹ guide, most cash-based businesses may have weak internal controls and have poor record keeping. However, at a minimum, businesses must document the flow of cash from its customers to the business. According to City Code Chapter 3.08, businesses "shall keep complete records of business activities and transactions including sales, receipts, purchases, expenditures and any other record and data relevant to establishing and verifying tax liability hereunder; and shall retain all such records and data for examination by the administrator for a period of at least three years." City Code Chapter 5.150 stipulated that "a dispensary shall acquire its supply of medical marijuana only from its members", and "shall not purchase or otherwise supply itself medical marijuana from nonmembers." Additionally, City Code requires the dispensary to produce the financial and membership records to the City within 24 hours after receipt of the City's request.

To analyze dispensaries' financial and membership records for compliance with City Code, we judgmentally selected a sample of six dispensaries and requested various financial and membership records from those dispensaries. Review of the financial records can help identify instances of underreported taxes, whereas examination of the membership records provides reasonable assurance that medical marijuana was obtained and distributed only to members. City Code requires that the dispensaries maintain all the information we requested. We requested documents from the period between January 1, 2016 to March 1, 2017. To ensure dispensaries received our requests for information, we hand-delivered letters to the selected dispensaries. We requested the dispensaries provide the requested records within 5 business days, which exceeded the City Code requirement that they provide them within 24 hours. It is important to note that we were only able to deliver five out of the six letters. Even with the hand delivery of the letters and the extended timeline, five dispensaries failed to produce the requested documents. One dispensary was not open on the three occasions we attempted to deliver the letter; therefore, it did not receive a letter.

Many of the documents we requested should have been readily available. For example, dispensaries should have been able to quickly produce their 2016 financial statements and their 2016 tax returns that were required to be submitted to the City during the 2017 permit renewal process. Records of the monthly gross receipts, and BOT receipts, membership list, vendor list, and sign-in/sales list are documents that dispensaries are also required to maintain and provide to the City upon request. It is important to note that these are the same types of records that dispensaries are required to supply to MuniServices when they perform audits of the dispensaries. The figure below shows the results of the documents we requested.

¹ IRS' Cash Intensive Business - Audit Techniques <https://www.irs.gov/businesses/small-businesses-self-employed/cash-intensive-businesses-audit-techniques-guide-table-of-contents> (April 2010 revision).

Figure 7: Results of Requests for Financial and Membership Documentation

Dispensary Name	GL Records	Monthly Gross Receipts Records	2016 Financial Statements	2016 Tax Returns	BOT Receipts	Membership List	Vendor List	Sign-in/Sales List
<i>All About Wellness</i>	X	X	X	X	X	X	X	X
<i>Community Health Solutions</i>	*	*	*	*	*	*	*	*
<i>Florin Wellness Center Inc.</i>	X	X	X	X	X	X	X	X
<i>Greenstone Biomass P.O.D.</i>	X	✓	X	X	✓	X	X	X
<i>Metro Health Systems, Inc.</i>	X	X	X	X	X	X	X	X
<i>SCCC</i>	✓	X	✓	✓	✓	✓	X	X

Note: We identified the documents we received with checkmarks and documents we did not receive with X's. Asterisks indicate that multiple attempts to deliver the letters were unsuccessful.

Source: Auditor generated based on documents provided by the dispensaries.

As the figure above illustrates, the dispensaries did not provide us with all requested documents². *SCCC* provided us with several financial documents; however, we were unable to validate the accuracy of the gross receipts reported on the financial statement and tax return due to missing monthly gross receipts records. *Greenstone Biomass P.O.D.* provided us with gross receipts records, but did not provide financial documents for comparison. *SCCC* provided us with the membership list but did not provide information about how it acquired (vendor list) or distributed (sign in/sales list) medical marijuana. As a result, we were unable to perform analysis of the selected dispensaries' gross receipts using their financial records. In addition, we were unable to assess if the dispensaries acquired and distributed

² In response to our request for additional information, one of the dispensaries notified our office that MMJ Freeway, a business management software used by some dispensaries, sustained an attack on its software infrastructure and is in the process of restoring data for their clients. *SCCC* and *Greenstone Biomass P.O.D.* were the two dispensaries affected by MMJ Freeway's software attack and were therefore unable to provide all data requested.

medical marijuana only to members. The dispensaries' failure to provide requested financial and membership documents hindered our ability to perform our intended analyses.

City Code requires that dispensaries maintain complete records of business activities and membership information and produce these documents upon request. It is important that the City have access to these records to administer and enforce compliance with BOT guidelines and ensure that dispensaries acquire and distribute medical marijuana only to their members. Failure to provide the financial documentation raises additional red flags and concerns regarding the potential for concealing gross receipts, which could lead to intentional underpayment of BOT. Failure to provide membership documentation raises concerns regarding potential acquisition and distribution of medical marijuana to non-members.

The City has recognized the importance of financial and membership records in its medical marijuana dispensary enforcement efforts by establishing in the City Code the requirement for the dispensaries to retain such records and produce the documentation within twenty-four hours of the City's request. The dispensaries' inability or unwillingness to provide the requested documentation is a violation of City Code and should be addressed. The IRS identified penalties as important tools to help the agency enhance voluntary compliance and meet its responsibilities of collecting proper tax revenue. The IRS may issue penalties to tax payers that fail to produce required tax statements. The City may benefit from implementing a penalty program similar to the IRS' and impose penalties to encourage compliance with City Code.

We recommend the Revenue Division determine why the dispensaries failed to produce the requested financial and membership documentation. In addition, the Revenue Division should request financial and membership documents from the dispensaries and inspect the documentation for signs of potential underreporting of BOT and for indicators that the dispensaries acquired medical marijuana from or distributed to non-members. In addition, the Revenue Division should consider imposing penalties to encourage compliance with document requests.

RECOMMENDATIONS

We recommend the Revenue Division:

1. Determine why dispensaries failed to produce the requested financial and membership documentation and inspect the documentation for compliance with City Code.
2. Consider imposing penalties to encourage compliance with document requests.

Underreporting of BOT May Be Discovered by Reviewing Financial Statements and Tax Returns

Financial statements are formal records of a business' financial activities, while tax returns contain financial information reported to the IRS; thus, it is important for the records to be complete and accurate. While these documents serve different purposes, we would expect to find the income and

expense information on a dispensary's financial statements and tax returns to be relatively consistent. To demonstrate the value of comparing financial documents, we reviewed financial statements and tax returns for the calendar years 2014 and 2015 that were submitted with the 2016 applications for the dispensary permit renewal applications.

Dispensary Financial Statements Compared to IRS Tax Returns

We compared the dispensaries' financial statements to their tax returns to evaluate the consistency between the amounts reported on the financial statements and the amounts reported to the IRS. Specifically, we reviewed the gross receipts (amount of sales), the cost of goods sold (cost of materials and labor to produce the product), and the rent expenses. We expected the gross receipts, the cost of goods sold and the rent to be similar on the financial statement and tax returns. Out of the 30 renewal applications we reviewed, nine contained the financial statements and the tax returns for the same period for comparison. A similar financial statement and tax returns comparison could not be performed on the other 21 dispensary files because they did not contain financial documents and tax returns, or did not contain financial statements and tax returns for the same period³. The figure below shows the discrepancies in the dispensaries' financial statements and tax returns for 2014 and 2015.

Figure 8: Comparison of Financial Statements and Tax Returns Data (Rounded to the Nearest Hundred)

Dispensary Name	Difference Between Financial Statements and Tax Returns for 2015			Difference Between Financial Statements and Tax Returns for 2014		
	Gross Receipts	Cost of Goods Sold	Rent Expenses	Gross receipts	Cost of Goods Sold	Rent Expenses
<i>Dispensary A</i>	\$0	\$0	\$0	-	-	-
<i>Dispensary B</i>	\$0	\$0	\$0	-	-	-
<i>Dispensary C</i>	\$0	\$0	\$0	-	-	-
<i>Dispensary D</i>	\$0	\$342,900	\$7,500	-	-	-
<i>Dispensary E</i>	\$0	\$0	\$0	-	-	-
<i>Dispensary F</i>	\$6,289,600	\$3,893,700	\$182,500	-	-	-
<i>Dispensary G</i>	-	-	-	\$0	\$892,300	\$48,800
<i>Dispensary H</i>	\$0	\$0	\$0	-	-	-
<i>Dispensary I</i>	\$0	\$25,700	\$0	-	-	-

Note: We indicated the discrepancies in red, and the lack of discrepancies in black. Lined (-) entries indicate that financial statement or tax returns for the period were not submitted.

Source: Auditor generated based on 2016 Medical Marijuana Dispensary Permit files.

As the figure above illustrates, four out of nine dispensaries reported different gross receipts, cost of goods sold, or rent expenses on their financial statements when compared to their tax returns of the same period. While we expected the amounts to be similar on the financial statement and the tax returns, there may be reasonable explanations for the discrepancies. However, inconsistencies in the financial information provided by the dispensaries may be considered red flags and should prompt the

³ We discuss implications of incomplete documentation in the applications process in Finding 3.

Revenue Division to perform additional research to determine the cause of inconsistency. Currently, the Revenue Division does not have a process for reviewing financial statements or tax returns.

Dispensary Gross Receipts on Financial Statements Compared to Gross Receipts Reported to the City

We also compared the amount of the gross receipts reported on the dispensaries' financial statements to the gross receipts reported to the City. Out of 30 renewal applications we reviewed, there were 17 dispensary applications that contained the 2015 financial statements submitted as part of the 2016 permit renewal process. Of the 17 dispensaries, we randomly selected a sample of six dispensaries to review⁴. We obtained the gross receipt data for 2015 from BizLINK, the City's BOT tax management system, which contains the dispensaries' self-reported gross receipts. We expected the gross receipts on the financial statements to be similar to gross receipts reported to the City. The figure below shows the discrepancies of the gross receipts reported on the financial statements when compared to the gross receipts reported to the City.

Figure 9: Comparison of 2015 Gross Receipt Reported on Financial Statement to the Gross Receipts Reported to the City (Rounded to the Nearest Hundred)

Dispensary	Difference Between Gross Receipts on Financial Statements and Amount Reported to the City
<i>Dispensary A</i>	\$29,300
<i>Dispensary B</i>	\$0
<i>Dispensary C</i>	\$21,900
<i>Dispensary D</i>	(\$221,200)
<i>Dispensary E</i>	\$3,200
<i>Dispensary F</i>	\$124,700

Source: Auditor generated based on the dispensaries' 2015 financial statements and BizLINK data.

As shown in the figure above, there appears to be discrepancies between five out of the six dispensaries' financial statements and their self-reported gross receipts to the City⁵. One dispensary reported \$220,000 less in gross receipts to the City than on its financial statement, which indicates that the dispensary may be underreporting its gross receipts. Discrepancies in the dispensaries' own data raises questions and demonstrates the need for further review. Currently, the Revenue Division does not have a process for comparing gross receipt data.

Our gross receipts comparison demonstrates the usefulness of financial statements to help identify discrepancies in the dispensaries' data. We recommend the Revenue Division develop a review process of the dispensaries' financial statements during the permit renewal process to identify red flags that may indicate potential underreporting of gross receipts.

⁴ We will discuss why some dispensary applications did not contain financial statements in Finding 3.

⁵ In a later section, we will address the completeness and accuracy of BizLINK data which may need to be taken into consideration when performing this type of comparison.

RECOMMENDATION

We recommend the Revenue Division:

3. Develop a robust review process of the dispensaries' financial statements during the permit renewal process to identify red flags that may indicate potential underreporting of gross receipts.

Dispensaries May Be Underreporting Gross Receipts

City Code Chapter 3.08 states that if there is reasonable cause to believe that the amount of tax paid is erroneous, the City may perform computations and determine the amount of tax required to be paid. The City enforces BOT rules by employing MuniServices to administer revenue audits to identify underreporting, and as applicable, assess the amount of BOT owed.

To develop our method of testing the accuracy of gross receipt reporting, we reviewed the *IRS' Cash Intensive Business – Audit Techniques* and contacted auditors from MuniServices and the California Board of Equalization⁶ (BOE) that have performed marijuana audits. The IRS' guide presented audit techniques to calculate gross receipts for various cash intensive business. One such technique is to establish an average sale per transaction and multiply the average to the total transactions. MuniServices reviews dispensary financial statements as part of their audit. As discussed in the previous section, the dispensaries failed to provide us with all requested financial documents; thus, audit techniques using financial records would provide minimal value. BOE staff recommended performing observations, and counting customers to calculate the dispensaries' gross receipts. Customer count was a method used in several BOE audits, which utilizes the average sale-per-customer and the customer count to determine taxes owed. The BOE obtained the average sale-per-customer via inquiry of the dispensary under review. While the methodology appears reasonable, we acknowledge that it is possible for dispensaries to provide inaccurate average sales per customer amounts because the value has not been established or because of their desire to intentionally underreport the value.

To obtain a more accurate average sale-per-customer number we observed four dispensaries during their operating hours⁶ and recorded sales transactions along with the number of customers. Once the sale-per-customer amount was obtained, we applied the BOE's and the IRS' gross receipts calculations to extrapolate the monthly gross receipts. Our calculations adjusted for high dollar purchases (\$1,000 or more) that may be inconsistent with a dispensary's normal sales and may inadvertently skew the gross receipts estimates. In addition, we elected not to use a global sale-per-customer average for our calculations, as dispensaries vary in sales production, and using such averages may inflate the gross receipts for some dispensaries.

Self-Reported Gross Receipts Compared to Auditor-Observed Sales

To evaluate the accuracy of the gross receipts dispensaries reported, we judgmentally selected a sample of six dispensaries to observe and record sales transactions. The dispensaries were selected based on their varying levels of self-reported gross receipts and whether they have been audited by MuniServices. Our sample included one dispensary that had been audited previously by MuniServices and one

⁶ The Board of Equalization (BOE) is a State agency charged with tax administration and fee collection. As of July 1, 2017, the administration over most tax and fee programs was transferred to California Department of Tax and Fee Administration.

dispensary that was, at the time, under review by MuniServices. In performing this test, our objective was to obtain conservative calculations of the dispensaries' gross receipts; therefore, we elected to observe the week after a well-known "4/20" or "Weed Day" event, where dispensaries advertised special promotions and giveaways. Interviews with dispensary staff confirmed that our observations took place during business days with relatively low transactions counts. We were able to successfully perform observations of sales transactions for four of the dispensaries in our sample⁷.

We recorded sales transactions and performed gross receipts calculations to obtain the auditor's observed gross receipts and BOT values on the four dispensaries. Our calculations for a dispensary with a daily operating schedule of 12 hours is as follows:

Observation = Sales recorded for 3 hours

Total day's sale = (Observation 1) + (Observation 2) + (Observation 3) + (Observation 4)

Average sale-per-customer = (Total day's sale) / (Total number of customers)

Gross receipts per month based on auditor observation = (Average sale-per-customer) X (Total day's sale) X 30

BOT per month based on auditor observation = (Gross receipts per month based on auditor observation) X 4%

We obtained the dispensary's self-reported gross receipts data from BizLINK for the period of January 2016 to June 2017⁸. Our calculations for the dispensary's self-reported average gross receipts per month is as follows:

Average self-reported gross receipts per month = (Total self-reported gross receipts recorded for period) / (Number of months with reported gross receipts)

We compared the estimated gross receipts based on auditor's observation to the dispensary's self-reported gross receipts. The figure below summarizes the results of our review.

⁷ We encountered difficulties with the other two dispensaries and will discuss the results of our attempts to perform testing in Finding 2.

⁸ In the next section, we will address the completeness and accuracy of BizLINK data which may need to be taken into consideration when performing this type of comparison.

Figure 10: Comparison of Gross Receipts Based on Auditor’s Observation to Self-Reported Gross Receipts (Rounded to the Nearest Hundred)

Dispensary Name	Gross Receipts Per Month Based on Auditor Observation	Average Self-Reported Gross Receipts Per Month (2016)	Difference in Gross Receipts Per Month	BOT Per Month Based on Auditor Observation	Average Monthly BOT (2016)	Difference in Monthly BOT
<i>Dispensary A</i>	\$643,000	\$273,800	(\$369,200)	\$25,700	\$11,000	(\$14,700)
<i>Dispensary B</i>	\$392,800	\$410,200	\$17,400	\$15,700	\$16,400	\$700
<i>Dispensary C</i>	\$124,900	\$162,300	\$37,400	\$5,000	\$6,500	\$1,500
<i>Dispensary D</i>	\$777,500	\$945,400	\$167,900	\$31,100	\$37,800	\$6,700

Note: Calculations were based on the gross receipts calculations in the IRS Guide to Audit Cash Intensive Businesses for gross receipts businesses and various BOE marijuana business audits.

Source: Auditor generated based on observed sales and BizLINK data.

As the figure above illustrates, the monthly average of *Dispensary A*’s self-reported receipts was \$273,800; however, we estimated that the dispensary’s gross receipts were \$643,000. Based on our analysis, the dispensary may be underreporting its gross receipts by nearly 57 percent. If our estimates were used to calculate the tax, *Dispensary A* may potentially be underpaying the City approximately \$14,700 a month, or \$176,400 per year. Our estimates for the other three dispensaries were slightly higher than what the dispensaries reported to the City, which was consistent with our intent to be conservative in our estimates.

We compared the dispensaries’ gross receipts to the auditor’s observed gross receipts to evaluate the accuracy of the gross receipts reported by the dispensaries for April 2017. For direct comparison, we reviewed BizLINK data using the same four dispensaries for our analysis. The figure below summarizes the results of our review.

Figure 11: Comparison of April 2017 Gross Receipts Based on Auditor’s Observations to Self-Reported Gross Receipts in April 2017 (Rounded to the Nearest Hundred)

Dispensary Name	April 2017 Gross Receipts Based on Auditor Observation	April 2017 Self-Reported Gross Receipts	Difference in Gross Receipts for April 2017	April 2017 BOT Based on Auditor Observation	April 2017 Self-Reported BOT Owed	Difference in BOT for April 2017
<i>Dispensary A</i>	\$643,000	\$293,100	(\$349,900)	\$25,700	\$11,700	(\$14,000)
<i>Dispensary B</i>	\$392,800	\$511,700	\$118,900	\$15,700	\$20,500	\$4,800
<i>Dispensary C</i>	\$124,900	Not reported	*	\$5,000	*	*
<i>Dispensary D</i>	\$777,500	\$938,800	\$161,300	\$31,100	\$37,600	\$6,500

Note: Asterisks (*) indicate that the gross receipts was not recorded in BizLINK. Implications of missing gross receipts are discussed in the next section.

Source: Auditor generated based on observed sales and BizLINK data.

As the figure above illustrates, *Dispensary A* appeared to have underpaid the City by approximately \$14,000 for April 2017. Based on our estimates of the BOT owed for April 2017, *Dispensary A* may have underreported its gross receipts by nearly 54 percent for the month. For the purpose of this audit, we did not investigate this anomaly further; however, the observation reinforces the need to perform this type of work on a larger sample and, as necessary, to investigate any irregularities.

As mentioned previously, the City’s Revenue Division relies on the medical marijuana dispensaries to self-report their gross receipts, and in turn, to determine their monthly BOT payments. The risk associated with relying on a business to self-report their gross receipts is that they have an incentive to underreport to reduce their tax liability. Based on our testing and observations, some dispensaries may be underreporting their gross receipts. In our opinion, the Revenue Division has not successfully addressed the cash-intensive nature of dispensaries in its tax collection process. The Revenue Division uses MuniServices to perform audits of the marijuana dispensaries; however, as we will discuss in a later section, the frequency and substance of the audits may not be sufficient to address concerns regarding underreporting of BOT. We recommend the Revenue Division perform observation tests of dispensaries, similar to the tests conducted by our office, to identify potential underreporting of gross receipts and consider collecting monies owed from dispensaries that are underreporting.

RECOMMENDATIONS

We recommend the Revenue Division:

4. Perform observation tests of dispensaries to identify underreporting of gross receipts.
5. Consider collecting monies owed from the dispensaries that underreport gross receipts.

The Revenue Division Should Improve Oversight of the BOT Program

City Code Chapter 3.08 states that since July 1, 2011, all marijuana businesses are required to remit four percent of their gross receipts to the City. The BOT payment is due on the first day of each month for the prior month. There is a \$15 penalty for payments that are more than 30 days late and a \$100 penalty for payments that are more than 60 days late. The City's Record Retention Schedule requires that the City retain records documenting revenues owed to the City by citizens, organizations, and vendors for five years. This includes documents pertaining to billing and collection of monies. Accurate and complete tracking of gross receipts and BOT payments are essential to ensure that the City can account for the amount the dispensaries owe and the amount the dispensaries paid. BOT owed for dispensaries are calculated based on four percent of the dispensaries' self-reported gross receipts. The Revenue Division tracks the dispensaries' gross receipts and BOT payments with BizLINK, the City's BOT tax management system, as well as with an Excel spreadsheet. According to the Revenue Division, the spreadsheet is used to supplement BizLINK's tax payment report.

To determine whether the Revenue Division accurately accounted for medical marijuana dispensaries' BOT amounts owed and BOT payments collected, we performed an analysis of the Revenue Division's records of the dispensaries' BOT data. The analysis included data from BizLINK, the City's BOT tax management system, and the Excel spreadsheet the Revenue Division uses to manually track dispensary financial data.

We created a query in BizLINK to obtain the self-reported gross receipts report between July 1, 2011 and April 30, 2017. We obtained the Monthly Tax Accounts Payments report from BizLINK for the period of August 1, 2011 to May 31, 2017, as payments are due on the first day of the month immediately following the reporting period. We computed the total self-reported gross receipts and multiplied the amount by four percent to obtain the projected BOT total. We compared the projected BOT owed to the BOT payments and found that there appeared to be an overpayment of over \$575,000. We summarized our findings in the figure below:

Figure 12: Comparison of BOT Owed to Payment Amounts (Rounded to the Nearest Hundred)

Self-reported Gross Receipts	\$385,282,200
BOT Owed (4% of gross receipts)	\$15,411,300
BOT Payments	\$15,987,000
Overpayment	\$575,700

Source: Auditor generated based on BizLINK data.

To identify the source of overpayment, we judgmentally selected a sample of three dispensaries and compared the gross receipts to the BOT payment. We performed calculations to determine the variance between gross receipts and BOT payments for the three dispensaries using data from BizLINK. During our analysis, we found that all three dispensaries' records in BizLINK did not contain gross receipts for all months which caused BizLINK to record no BOT owed for those months. We adjusted for the unrecorded gross receipts by identifying the missing months and used the preceding month's data for the analysis. Similar calculations were performed to determine the variance between the adjusted BOT owed and

BOT payments. We compared the two calculations and summarized the results of our review in figure 13.

Figure 13: Comparison Between BOT Owed for Unadjusted and Adjusted Gross Receipts July 1, 2011 to April 30, 2017 (Rounded to the Nearest Hundred)

<i>Dispensary A</i>			
Self-reported Gross Receipts	\$57,144,000	Adjusted Gross Receipts	\$59,737,200
BOT Owed (4% of gross receipts)	\$2,285,800	Adjusted BOT Owed	\$2,389,500
BOT Payments	\$2,382,100	BOT Payments	\$2,382,100
Overpayment	\$96,300	Underpayment	(\$7,400)
<i>Dispensary B</i>			
Self-reported Gross Receipts	\$26,226,300	Adjusted Gross Receipts	\$27,823,900
BOT Owed (4% of gross receipts)	\$1,049,100	Adjusted BOT Owed	\$1,113,000
BOT Payments	\$1,088,000	BOT Payments	\$1,088,000
Overpayment	\$38,900	Underpayment	(\$25,000)
<i>Dispensary C</i>			
Self-reported Gross Receipts	\$28,027,400	Adjusted Gross Receipts	\$28,555,700
BOT Owed (4% of gross receipts)	\$1,121,100	Adjusted BOT Owed	\$1,142,200
BOT Payments	\$1,110,100	BOT Payments	\$1,110,100
Underpayment	(\$11,000)	Underpayment	(\$32,100)

Source: Auditor generated based on observed sales and BizLINK data.

As noted above, missing gross receipts can produce misleading results. For instance, *Dispensary A* appeared to have overpaid BOT by \$96,300; however, our analysis of the adjusted gross receipts shows that the dispensary could have underpaid by \$7,400.

Next, we compared Revenue Division’s payment records to dispensary payment receipts to determine if all payments are tracked. As indicated in a previous section, we requested BOT receipts from six dispensaries; however, we only received BOT receipts from two dispensaries. We compared BizLINK reports and the Excel spreadsheet to payment receipts provided by the dispensaries from January 2016 to March 2017. We identified a \$6,000 payment that was not recorded in the BizLINK report or the Excel spreadsheet. Further review showed that while the payments were collected and applied to appropriate City accounts, the payments do not appear on the Revenue Division’s marijuana BOT payment records. We recognize that the test result was based on the review of limited data and we cannot ascertain if the missing BOT payment record was a single incident or a normal occurrence. Nonetheless, unrecorded payments can contribute to and exasperate the variance between the BOT owed and the BOT paid. We inquired with the Revenue Division about additional factors that may have contributed to the appearance of BOT overpayment by the dispensaries. Revenue Division staff indicated that the gross receipt report did not reflect transactions that required manual adjustments; therefore, it captured the incorrect gross receipt amount. In addition, the BOT payment report contained payment amounts that included BOT owed along with fees and penalties paid. For example, a \$130 payment could include a \$114 BOT payment, a \$15 late penalty, and a \$1 State fee. Inaccurate gross receipts and BOT payment records could contribute to the appearance of a BOT overpayment.

Based on our analysis, it appears the Revenue Division needs to improve its tracking of BOT owed and BOT payments to accurately report the amount the dispensaries owed and paid to the City. Additionally, the variance in our analysis shows that the Revenue Division has not reconciled the BOT data. It is important for the City to maintain records of gross receipts and BOT payments, as it enables the City to identify deficient payments and enforce BOT rules. Additionally, incomplete and inaccurate tracking of BOT prevents the City from accurately reporting revenue generated from medical marijuana dispensaries. As the marijuana businesses in City grow into other areas including cultivation and manufacturing, it becomes more important for the Revenue Division to provide accurate reports of revenue to enable the City to make informed decisions when establishing the amount of resources that will be needed to regulate the marijuana industry.

We recommend the Revenue Division establish controls to ensure self-reported gross receipts are recorded and establish a process to reconcile payments owed to payments received.

RECOMMENDATIONS

We recommend the Revenue Division:

6. Develop controls to ensure dispensaries' gross receipts are recorded monthly.
7. Establish a process to reconcile payments owed to payments received.

MuniServices' Audit Findings Were Not Sufficiently Addressed

The City uses the revenue audits conducted by MuniServices as a tool to monitor and enforce City ordinances. MuniServices reviews compliance with the BOT rules and applicable laws and guidelines for the operation of medical marijuana dispensaries. The results of MuniServices audits are presented to the Revenue Division. The Revenue Division is responsible for determining the applicability of MuniServices' tax deficiencies findings and enforcing applicable City Code. As these audits serve as a monitoring tool, the Revenue Division should have processes in place to address MuniServices' audit findings to ensure compliance with City Code and applicable State laws and regulations. As of June 2017, MuniServices has completed audits of 10 dispensaries and is in the process of reviewing five additional dispensaries.

To determine if MuniServices' audit findings were addressed, we obtained completed MuniServices' audit reports and reviewed the Revenue Division's process for following up with those findings. Our review found that Revenue Division has addressed financial findings, and as necessary, collected on identified tax deficiencies. However, we found that the Revenue Division has not addressed issues regarding non-compliance with State laws and regulations. Specifically, *River City Phoenix* did not allow MuniServices to tour the facility. By refusing to provide a tour, the dispensary violated City Code that allows City officials to enter and inspect the dispensary. Facility tours provide insights to the dispensary's operations that may not be identified by reviewing financial documents. Additionally, *River City Phoenix* did not provide information about its marijuana suppliers; therefore, MuniServices was unable to

determine if the dispensary purchased its entire inventory from members. State laws require that dispensaries obtain medical marijuana only from its members to safeguard against diversion for non-medical purposes. We inquired with the Revenue Division about the audit findings, and staff indicated that the non-financial findings were overlooked and were not addressed.

In order to effectively regulate medical marijuana businesses, the City should perform complete reviews of MuniServices' audit reports to identify and address instances of non-compliance. Because the Revenue Division did not address all of the MuniServices' audit findings, they allowed the dispensary to continue to operate in violation of City Code. We recommend the Revenue Division implement controls to ensure complete reviews of MuniServices' audit reports and address *River City Phoenix's* audit findings.

RECOMMENDATIONS

We recommend the Revenue Division:

8. Implement controls to ensure complete reviews of MuniServices audit reports.
9. Review and address MuniServices' audit findings regarding *River City Phoenix*.

The Frequency of Audits Should Be Reevaluated to Ensure Timely Coverage of All Dispensaries

Medical marijuana businesses have been licensed and regulated in Denver, Colorado⁹ since 2010. To learn more about jurisdictions with mature medical marijuana programs, we contacted Denver's Audit Department to determine the frequency of their marijuana business audits. According to the Denver Auditor's Office, Denver performs audits of approximately 30 percent of their marijuana businesses each year. This way, they can achieve complete coverage of all marijuana businesses approximately every 3.5 years.

At the City of Sacramento, audits are performed on behalf of the City's Revenue Division by MuniServices LLC, a vendor that performs medical marijuana deficiency audits to ensure dispensaries are remitting appropriate BOTs to the City and are operating in compliance with applicable State laws and City Code. MuniServices audits are pre-announced and typically take eight to nine months to complete. The MuniServices auditors will perform one site visit to learn about dispensary operations, request financial records and membership lists, and perform data analysis based on documents submitted by the dispensaries. According to the Revenue Division, MuniServices performs five audits per year. As the City of Sacramento has 30 licensed dispensaries, this equates to approximately 17 percent of dispensaries per year. At that rate, it would take six years to achieve 100 percent audit coverage. This is nearly half of the frequency with which Denver audits its marijuana businesses.

⁹ Denver, the capital of Colorado, is a consolidated city and county.

In our opinion, the current audit frequency may not be sufficient to provide appropriate oversight of the dispensaries. Additionally, medical marijuana dispensaries' cash intensive nature necessitates more frequent oversight. Lack of oversight could lead to underreporting which, at the current rate, could go undetected for up to six years. We recommend the Revenue Division reassess the frequency of MuniServices audits to ensure complete audit coverage of all dispensaries in a timely manner.

RECOMMENDATION

We recommend the Revenue Division:

10. Reevaluate the frequency of MuniServices audits to ensure appropriate coverage of the medical marijuana dispensaries in a timely manner.

Finding 2: Medical Marijuana Dispensaries Are Not Complying with the City's Operating Requirements

The California Department of Alcoholic Beverage Control (ABC) was established to protect California communities through alcohol regulation and education. ABC developed the IMPACT Program in 1984 with the goal of reducing alcohol-related crime in and around licensed premises by inspecting sites, identifying instances of non-compliance, taking appropriate enforcement action, and conducting follow-up visits. The program's enforcement model encourages compliance through educating liquor merchants and will take action if the IMPACT team identify major violations. In addition, the program identifies high-risk violations that may necessitate fines or suspension and revocation of liquor permits. ABC has established administrative penalties "in a consistent and uniform manner with the goal of encouraging and reinforcing voluntary compliance with the law."

The effects of permitting the establishment of marijuana dispensaries brings with it concerns similar to those posed by liquor stores regarding negative secondary effects on public health, safety, and welfare. These concerns include an increase in crime such as burglary, robbery, and illegal distribution of substances. The City of Sacramento has an enforcement program that includes site inspections to ensure dispensaries comply with City Code rules and regulations. However, the City can benefit from incorporating additional enforcement elements of the ABC IMPACT Program to ensure dispensaries comply with City Code. Specifically, we found:

- The site inspection process is not comprehensive and failed to identify instances of non-compliance;
- One dispensary refused to grant the Office of the City Auditor access to the dispensary;
- Not all dispensaries are subject to the same operating requirements; and
- One dispensary may no longer be operational.

An effective marijuana enforcement program can help to improve compliance with City Code and State laws. The program should include uniform operating requirements for all dispensaries, formal documentation of violations, and a follow-up process to ensure instances of non-compliance are corrected.

The Site Inspection Process is Not Comprehensive and Failed to Identify Instances of Non-Compliance

The Code Enforcement Division is a subdivision of the Community Development Department (CDD) who helps maintain the quality of the community through education and enforcement. According to the CDD website, the “Business Compliance section works with city departments to issue permits and licenses and enforce state and local codes and ordinances.” In addition, the Business Compliance section “makes business inspections to ensure code compliance and help maintain public health, safety and welfare of Sacramento residents.” To fund the medical marijuana enforcement efforts, the City has allocated part of the annual permit renewal fees to fund one full time equivalent Zoning Investigator. CDD uses two Zoning Investigators who split their time to perform enforcement duties at the medical marijuana dispensaries.

The City’s regulation of medical marijuana dispensaries is similar to that of the ABC in that both entities work to protect the health, safety, and welfare of the public. Specifically, the ABC’s IMPACT Program stated that its objectives are to conduct visits and inspections of licensed premises, identify instances of non-compliance at licensed premises, take appropriate enforcement action on any major violations observed, and conduct follow up visits as needed to check for compliance. Although the City’s medical marijuana dispensary program is not subject to the provisions of ABC, we used ABC’s IMPACT Program as a guideline for an effective enforcement program in our review.

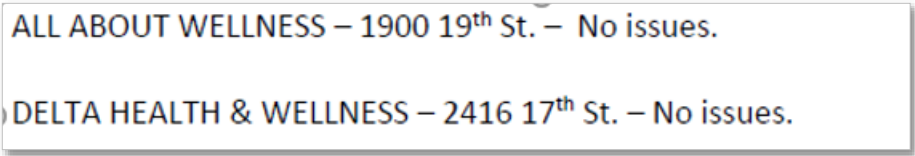
The ABC’s IMPACT team randomly inspects licensed premises and uses a checklist to record their inspections. Violations are noted on the checklist and a copy is provided to the licensee. A follow-up visit is performed in approximately 20 days to verify that the licensee corrected the violations. If the violations are not being remedied, the IMPACT team records the incident on the checklist and forwards the information to a local ABC district for review to determine possible disciplinary action against the licensee.

To learn about the City’s medical marijuana dispensary code enforcement process, we engaged a Zoning Investigator with the CDD and participated in a site inspection ride-along. The Zoning Investigator informed us that the purpose of a site inspection is to verify compliance with Chapter 17.228, which regulates land use and the dispensaries’ CUP conditions of approval. In addition, the inspections also review matters such as gaining immediate access to the dispensary, verifying doors are secured, witnessing the presence of a security guard, observing no loitering, monitoring for no consumption of marijuana on site, and confirming posting of appropriate signage. Site inspections may consist of onsite visits or observations of the dispensaries from the outside. When the Zoning Investigator identifies instances of non-compliance with City Code during a site visit, the dispensary manager is notified verbally and instructed to correct the problem. If the problem persists, the City can suspend or revoke the dispensary’s permit. However, it is important to note that CDD does not have any formal procedures that provide guidance to staff on how to perform medical marijuana dispensary site inspections, or that outlines what is expected of them when they identify issues of non-compliance. Inspection results are

compiled in a memorandum that serves as CDD’s internal records of the inspection; the information is subsequently entered into CitizenServe, the City’s official code enforcement records system.

A CUP’s conditions of approvals are initially recommended by various agencies, groups, and City departments including the City’s Planning Division, Building Division, and Police Department to reduce the effects of the presence of medical marijuana dispensaries in a community. The conditions may include requirements for dispensaries to display certain signs, obtain armed security officers, limit its operating hours, and/or ensure the name of business is printed on receipts. The conditions of approval varied between the dispensaries, so the requirement of one dispensary does not necessarily apply to another dispensary. To verify the whether site inspections addressed compliance with Chapter 17.228 and the dispensaries’ CUP conditions of approval, we reviewed the inspection results. We expected the results to contain information regarding what the Zoning Investigator reviewed and the outcome of the inspections. Below are examples of inspection results found on the memorandum and CitizenServe.

Figure 14: Examples of Inspection Results from Memorandum



Source: Screenshot of a CDD Site Inspection Memorandum.

The figure above is an example of how a Zoning Investigator recorded incidents of compliance at two dispensaries with the notation of “no issues”. While no issues were identified, the Zoning Investigator’s inspection notes did not specify the type CUP compliance checks performed. Additionally, the inspection result did not specify if the inspections were onsite visits or observations of the dispensaries’ perimeters. We were unable to assess what types of compliance tests were performed at the dispensaries, as the inspection results did not contain information regarding the items that were under review.

Figure 15: Example of Inspection Results in CitizenServe

Most Recent First ▼		Notes & Activity Events ▼		
Mar 10, 2017 02:03 PM	RE-INSPECTION - Activity Note	3/10/17 at 1245 hrs. Re-Inspection: All seems in order, no issues.	[REDACTED]	Private
Mar 10, 2017 02:03 PM	RE-INSPECTION - Activity	A RE-INSPECTION activity has been assigned to [REDACTED] in the Business License department.	[REDACTED]	Public
Feb 10, 2017 12:15 PM	RE-INSPECTION - Activity Note	2/10/17 at 1013 hrs. Re-Inspection: All seemed in order, no issues.	[REDACTED]	Private
Feb 10, 2017 12:15 PM	RE-INSPECTION - Activity	A RE-INSPECTION activity has been assigned to [REDACTED] in the Business License department.	[REDACTED]	Public

Source: Screenshot of dispensary inspection results in CitizenServe.

The figure above shows the site inspection notes of at a dispensary recorded in CitizenServe. The inspection yielded “no issues”. Similar to the memorandum described above, notes in CitizenServe lack details describing the type of compliance tests reviewed.

As illustrated by the figures above, the site inspection results do not provide details regarding the items reviewed during the site inspections. Due to the lack of details regarding the compliance tests performed by CDD, we were unable to assess the type of compliance review performed during the site inspections. As a result, we were limited in our ability to perform a review or provide an assessment regarding the effectiveness of the site inspection process using CDD’s inspection records.

Surprise Inspections Performed by the Office of the City Auditor Identified Dispensaries Are Not Complying with Operating Requirements

To verify whether the Zoning Investigators have been effective in mitigating instances of non-compliance with City Code, we selected a sample of six dispensaries and performed surprise inspections. We judgmentally selected the sample based on their varying levels of self-reported gross receipts and whether they had been audited by MuniServices. Our sample included one dispensary that had been audited and one dispensary that was, at the time, under review by MuniServices. This selection criteria enabled us to identify the dispensary that underwent MuniServices’ audit without significant findings as a baseline for our audit. It is important to note that all dispensaries are subject to CDD’s surprise inspections monthly and MuniServices’ site visit.

We conducted our surprise inspections using a checklist that we developed specifically for this purpose. The checklist included verification of the following items:

- Adequate signage and notices are posted both outside and inside the dispensaries;
- The front door and sales room door are secured;
- Sales are for medical marijuana and related products only (no commercial products);
- Marijuana is not consumed on site; and
- Notate additional findings as appropriate.

We were able to complete surprise site inspections at four dispensaries, inspect the lobby and perimeter of one dispensary, and inspect the perimeter of another dispensary. The results of our inspections are outlined in the figure below.

Figure 16: Results of Surprise On-Site Inspections

Dispensary Name	Required Signs Are Posted	Doors Are Secured	Sales Only to Qualified Patients	No Sale of Commercial Products	No Onsite Consumption of Marijuana	Provided All Requested Records
<i>All About Wellness</i>	✓	X	*	*	*	X
<i>Community Health Solutions</i>	X	*	*	*	*	*
<i>Florin Wellness Center Inc.</i>	✓	X	X	✓	✓	X
<i>Greenstone Biomass P.O.D.</i>	X	✓	X	✓	✓	X
<i>Metro Health Systems, Inc.</i>	X	✓	✓	X	X	X
<i>SCCC</i>	✓	X	✓	✓	✓	X

Note: We identified compliance with checkmarks and non-compliance with X's. Asterisks indicated items we were not able to observe because the dispensary was not open or we were denied access to those areas.

Source: Auditor generated based on inspection results.

Our inspection results show that none of the six dispensaries in our sample were fully in compliance with City Code. As discussed in Finding 1, none of the dispensaries provided us with all requested financial or membership records. In addition to our checklist test, we observed the following questionable activities at the dispensaries:

- *All About Wellness* did not grant the Office of the City Auditor access to inspect the dispensary.
- *Community Health Solutions* does not appear to be in operation. We visited the dispensary on three different occasions at its stated operating hours and found the front door was locked and no activity.
- *Florin Wellness Center Inc.* sold marijuana to a patient with an expired medical marijuana recommendation. In addition, the dispensary violated operating requirements by allowing 420 Med Evaluations, a business advertised to provide medical marijuana recommendations, to provide services at the dispensary during its 4/19 Member Appreciation Day.
- *Greenstone Biomass P.O.D.* appeared to participate in marijuana delivery services, which is currently prohibited.
- *Metro Health Systems, Inc.* employee appeared to accept marijuana samples from the onsite vendor and consumed the product on site.
- *SCCC* sold 50 marijuana plants to one patient, which exceeds the State's established guideline that allows each patient to possess up to 12 immature plants.

These instances of non-compliance indicate that the City's current site inspection process is not effective in mitigating certain issues. In our opinion, site inspections serve as the City's primary enforcement effort so it is essential that the inspections are effective in identifying and resolving instances of non-compliance. It is also concerning that we were not given access to inspect one dispensary in our sample despite our legal authority.

We shared the inspection results with CDD. According to CDD management, the Zoning Investigators were directed to inspect the dispensaries for land use requirements and the dispensaries' CUP conditions of approval since the position is funded by the medical marijuana program. While the Zoning Investigators may review some Chapter 5.150 operating requirements during their site inspections, that was not the primary focus of their inspections.

We performed an analysis to assess if CDD has sufficient resources to perform inspections. CDD is budgeted one full-time equivalent employee to perform medical marijuana dispensary inspections. Based on a forty-hour work schedule, a full-time employee works approximately 174 hours per month. According to CDD staff, each site inspection takes approximately two hours, which covers travel time, site inspection, and report writing. Using this estimate, we multiplied the 2 hours needed to perform a site inspection by the total number of dispensaries to obtain the number of hours required to perform all site inspections each month: 2 hours X 30 dispensaries = 60 inspection hours. While we did not assess the reasonableness of use of the excess hours, there appears to be an excess of over 100 work hours per month allotted for CDD staff to perform dispensary inspections. The extra resource could be used to incorporate Chapter 5.150 to CDD's dispensary site inspections and enforcement efforts.

As practiced by ABC, an effective compliance program should include formal procedures and outline a process that includes following up on violations to ensure they have been remedied. The enforcement program should assess the risk level of the various violations and determine the appropriate level of follow-up to resolve the violations, as high-risk violations may require additional monitoring. Currently, the City Code states that the City may suspend, modify or revoke a permit; however, it serves as an end-all solution for non-compliance and does not allow for progressive levels of enforcement. The City may benefit from implementing an enforcement program similar to ABC's, which includes imposing penalties to encourage compliance with City Code. In our opinion, proactively educating dispensaries on what is expected of them and identifying issues of non-compliance in a timely manner will aid dispensaries in addressing issues before they become larger problems and help them to successfully operate in a responsible and effective manner.

RECOMMENDATIONS

We recommend the Community Development Department:

11. Assess the hours spent on dispensary inspections to determine whether CDD has adequate or excess resources.
12. Develop and memorialize, in a policy, a risk-based enforcement program that identifies high risk violations and implement a follow-up process to ensure violations are resolved in a timely manner.
13. Consider imposing penalties to encourage timely compliance with City Code.

One Dispensary Refused to Grant the Office of the City Auditor Access to the Dispensary

City Code Chapter 5.150 states that City officials may enter and inspect the dispensary property and dispensary records to ensure compliance and to enforce City Code. The Code states that “no person shall refuse, impede, obstruct or interfere with an inspection” to enforce City rules. Additionally, Chapter 3.08 requires that a business keep complete records of business transactions (including sales and receipts) and allow the City to examine such records. The City exercised such authorities via CDD’s unannounced monthly site inspections and MuniServices’ audits, who include one onsite visit as part of their audit plan. As mentioned in the previous section, four of the dispensaries in our sample granted us access to their facilities, one dispensary was not open, and one dispensary refused to grant access.

On three different occasions, the *All About Wellness* dispensary refused to grant the Office of the City Auditor access to the dispensary so that we could perform site inspections and observe sales transactions. A summary of our attempts to inspect the facility are as follows:

- On the afternoon of April 26, 2017, the City Auditor’s staff arrived at the dispensary with a police officer dressed in plain clothes. The owner was not present and spoke to the City Auditor’s staff and the police officer via phone. The owner was aggressive and used inappropriate and offensive language to express displeasure with the audit. However, the owner expressed the desire to cooperate with the audit under the condition that he is present during the inspection. Prior to leaving, the City Auditor’s staff provided the dispensary with an audit packet which included a letter from the Revenue Manager notifying the dispensary of the audit and a memorandum requesting the dispensary produce financial documents by May 5, 2017.
- The City Auditor arrived at the dispensary on April 27, 2017 at 10:00 a.m., during a time the owner indicated that he would be present. The owner was not present but dispensary security personnel indicated to the City Auditor that the owner would arrive in one hour. The City Auditor left the dispensary and agreed to return one hour later, at the owner’s stated arrival time.
- The City Auditor returned to the dispensary on April 27, 2017 at 11:00 a.m. at the dispensary owner’s request. The City Auditor did not see the owner but was informed by a dispensary representative that the request for access was denied.

- In addition to denying us access, the dispensary did not produce the requested financial and membership documents.

In their objection to the audit, the dispensary cited concerns regarding the Health Insurance Portability and Accountability Act (HIPAA), a federal law protecting the privacy of health information. The U.S. Department of Health & Human Services, a government agency that developed the regulations of the HIPAA Privacy Rule, identifies protected health information as “individually identifiable health information” that relates to the details of the individual’s health condition, the provisions of health care, and payments for the provision of health care. It is important to note that our audit observations and tests did not request HIPAA-protected information. As the permitting agency, the City of Sacramento has the right to enter, inspect, and observe the dispensary’s sales transactions. It is also important to note that *All About Wellness* had previously granted access to CDD staff to inspect the dispensary without notice and permitted MuniServices to visit the facility. *All About Wellness’* newfound objection to site inspections is therefore, suspect. The dispensary’s refusal to allow the Office of the City Auditor access to the facility impeded our ability to carry out our audit on behalf of the City.

The City has recognized the elevated need to monitor and regulate medical marijuana dispensaries by designating the City’s inspection authority in the City Code. By repeatedly refusing to grant the Office of the City Auditor access, the dispensary was deliberately ignoring the City’s inspection authority. As discussed in Finding 1, *River City Phoenix* refused to comply with City Code by not allowing MuniServices auditors to tour the facility. These incidents diminish the City’s authority and ability to regulate the dispensaries. The actions by *All About Wellness* reinforces the need for the City to strengthen oversight of the dispensaries. We recommend the City to formally direct the Office of the City Auditor to inspect the All About Wellness to ensure the dispensary is complying with City Code and State laws, and consider engaging the Office of the City Auditor to perform similar audits at additional dispensaries. In addition, we recommend the Revenue Division reevaluate the language in the City Code, and if necessary, strengthen the Code to make it abundantly clear that the City has the legal right to enter and inspect the dispensaries.

RECOMMENDATIONS

We recommend the Revenue Division:

14. Engage the Office of the City Auditor to perform inspections at *All About Wellness* to assess whether the dispensary is complying with City Code and State laws.
15. Reevaluate the language in the City Code, and if necessary, strengthen the Code to make it clear that the City has the legal right to enter and inspect dispensaries’ property and financial records.

Not All Dispensaries Are Subject to the Same Operating Requirements

As part of the CUP approval, the City imposed additional operating requirements that dispensaries must follow in order to obtain their permit. In addition, dispensaries are subject to operating requirements outlined in City Code Chapter 5.150. Operating requirements in Chapter 5.150 are consistent for all

dispensaries; however, operating requirements specified in the CUPs could vary between the dispensaries. In general, consistent rules and enforcement avoid the appearance of selective partiality and demonstrate that all businesses are being treated the same.

We reviewed a sample of six dispensaries' conditions of approval to assess if the CUPs were addressing similar areas of risk¹⁰. The figure below displays the results of our sample of six CUP conditions of approval testing.

Figure 17: CUP Requirements by Dispensary

Dispensary Name	Date of CUP Approval	Security Measures*	Height Markers	No Trespassing Sign	Good Neighbor Sign	Non-Illuminated Sign	Business Name on Sales Receipts
<i>All About Wellness</i>	09/22/11	X	X	X	X	X	X
<i>Community Health Solutions</i>	11/20/14	✓	✓	✓	✓	✓	✓
<i>Florin Wellness Center Inc.</i>	02/27/14	✓	✓	✓	✓	✓	X
<i>Greenstone Biomass P.O.D.</i>	11/20/14	✓	✓	✓	✓	✓	✓
<i>Metro Health Systems, Inc.</i>	10/30/14	✓	✓	✓	✓	✓	✓
<i>SCCC</i>	09/22/11	✓	X	X	X	X	X

Note: We identified required conditions with checkmarks (✓) and conditions that are not required with X's.

*For safety reasons, specifics about security measures were not identified.

Source: Auditor generated based on CUP data.

As the figure illustrates, the conditions of approval are not similar between the dispensaries. *All About Wellness* has the minimum amount of conditions when compared the other dispensaries, while *Community Health Solutions*, *Greenstone Biomass P.O.D.* and *Metro Health Systems, Inc.* are subject to the most conditions. The Revenue Division and CDD staff indicated that dispensaries that obtained their CUPs in 2011 were subject to fewer conditions than those that obtain their CUPs in 2014. They explained that as some marijuana regulations evolved with new knowledge and gained experience, the City added new conditions to the CUPs. The Revenue Division agreed that conditions addressing security and signage should be consistent across all dispensaries. According to CDD management, the City cannot impose new conditions to established CUPs. However, operating requirements could be updated as part of the dispensary permit renewal process. We recommend CDD and the Revenue Division review and update the dispensaries' operating requirements to reduce the potential appearance of favoritism and ensure consistent enforcement practices.

¹⁰ There may be other conditions of approval requirements that are not listed here.

RECOMMENDATION

We recommend the Community Development Department and the Revenue Division:

16. Review and update the dispensaries' operating requirements to ensure consistent enforcement practices.

One Dispensary May No Longer Be Operational

City Code Chapter 17.228 states that, "the conditional use permit shall expire for discontinuance of use and shall thereafter be void if the medical marijuana dispensary ceases operation at any time, voluntarily or involuntarily, for 30 consecutive days." Ultimately, the City could revoke dispensary CUPs and, in turn, their dispensary permits if the dispensaries close their doors for 30 consecutive days. We learned that in May 2016, *Community Health Solutions* notified the City of its limited operating hours of Saturdays from 1:00 p.m. to 5:00 p.m. In April and May 2017, we visited the dispensary on three occasions during its stated operating hours and found no activity. A nearby business owner stated that no activity has been observed at the dispensary location and that the dispensary is likely closed. As the dispensary has not been inspected for the previous ten months, we cannot determine how long the dispensary may have been closed. However, our review of *Community Health Solutions'* BOT records indicate that the dispensary has remitted BOT to the City since March 2016 although the dispensary did not appear to be open during our inspections. Consequently, *Community Health Solutions* has retained the rights to its dispensary permit despite limited sales activities or possible closure.

If the City intends on enforcing the discontinuance of use rule, then there should be a formal process in place to detect dispensaries that may no longer be operational. The City should also reevaluate and clarify the time frame associated with the discontinuance of use rule. In addition, the Revenue Division should follow up with *Community Health Solutions* to determine if the dispensary is still operational.

RECOMMENDATIONS

We recommend the Revenue Division:

17. Reevaluate and clarify City Code regarding the timeframe associated with discontinuance of use.
18. Follow up on *Community Health Solutions* to determine if the dispensary is operating.

Finding 3: The Revenue Division Could Benefit from Improved Recordkeeping and More Thorough Reviews of Dispensary Permit Applications

Complete and accurate records of dispensary applications are essential to demonstrate that the Revenue Division obtained required information and performed their due diligence by thoroughly reviewing permit applications. As discussed in the background section, phase one and phase two applications for dispensary permits required that the dispensaries provide the City with documentation including their business operations, financial status, and security plans. The purpose of the application process was to ensure applicants that qualify under City Code would receive dispensary permits. The City's Revenue Division was tasked with reviewing the applications and for granting the dispensary permits. During our review of the applications, we found:

- The Revenue Division's review process lacks controls to ensure compliance with permit application requirements; and
- The Revenue Division could better document dispensary management member, location, and entity name changes.

It is unclear whether the Revenue Division did not obtain, or failed to retain, required permit application documents. An effective application review process provides assurance that only applicants that provided sufficient evidence were deemed qualified to operate medical marijuana dispensaries in the City. As City Code prohibits transfer of dispensary permits, the Revenue Division could have obtained better documents to support its decision-making process for granting permits to dispensaries with changes to management members, location, and entity name.

The Revenue Division's Review Process Lacks Controls to Ensure Compliance with Permit Application Requirements

In order to obtain a permit to operate in the City, medical marijuana dispensaries were required to prove their qualifications by submitting applications for all phases of the application process, including the initial registration, phase one, and phase two. Once permitted, dispensaries are required to provide ongoing proof of qualification by submitting annual renewal applications. City Code Chapter 5.150 and Ordinance 2009-033 identified the documents applicants were required to submit for the application process. These documents serve as evidence to certify eligibility of applicants, and their intent to operate in accordance with applicable laws and regulations. According to City Code Chapter 5.150, the City may deny the application if it deems the application to be incomplete.

Complete and sufficient review of applications is crucial to help the City make informed decisions and to provide assurance that only qualified applicants are operating licensed medical marijuana dispensaries. We reviewed the supporting documentation for the initial registration, phase one, phase two, and the 2016 renewal applications to determine if the documentation appeared to be sufficient to meet the requirements outlined by City Code Chapter 5.150 and Ordinance 2009-033.

The City's Record Retention Schedule requires that the City retain records pertaining to permits for five years, and that no records will be destroyed until they meet the minimum retention period. According to the Retention Schedule, the destruction of such records must be approved by the City Clerk and City Attorney. We interviewed the Revenue Division and they informed us that no destruction of medical marijuana dispensary records was performed. We should note that during the audit, we were notified that the Revenue Division had experienced a change in staffing of the Program Analyst assigned to oversee the medical marijuana program in June 2013. As a result, historical knowledge of the program may be incomplete.

The Revenue Division's Medical Marijuana Registration Records Were Complete

In 2009, the City allowed for an "Exemption of Established Operations" in Ordinance 2009-033 for a medical marijuana dispensary if the dispensary applied and could prove that the dispensary had been providing marijuana services in the City since at least June 16, 2009. The exemption allowed for the dispensaries to operate within the City. Dispensaries that did not meet the exemption were ordered to cease operations. The Ordinance stated that an "application shall be submitted on a form provided by the Revenue Manager and should include originals or true and correct copies" of the following:

- State Board of Equalization Seller's Permit;
- Commercial or business insurance policy with liability insurance coverage;
- Rental contract, lease, or current property deed; and
- Any additional evidence that the dispensary is an "established operation" by submitting an application timely and has been operating as a marijuana dispensary since at least June 16, 2009.

Additionally, the applications "shall include a true and correct copy of a BOT certificate." The Ordinance further states that "the city manager or his/her designee shall evaluate each application, conduct a reasonable investigation, and determine whether the applicant is an established operation."

To assess whether the Revenue Division performed sufficient reviews of the initial applications and granted "registered" status to only eligible dispensaries, we reviewed the electronic and paper files of the registration applications. Thirty-nine applicants were approved as "registered" medical marijuana dispensaries and qualified for the phase one application process. Based on our review, we found that the Revenue Division obtained and retained evidence that demonstrated that the 39 registered dispensaries had been operating since at least June 16, 2009.

In addition to the approved applications, we also inquired about dispensaries that submitted registration applications but were denied the exemption status. Our review of the documentation showed one application was denied due to the desire to register for a second or future location. We found the Revenue Division's denial of the dispensary's request to be appropriate as the exemption status was only for dispensaries that were already operating at the time of the registration.

The Revenue Division obtained and retained adequate documentation and performed sufficient review to ensure only qualified applicants were approved and granted the “registered” status.

The Revenue Division’s Medical Marijuana Phase One Records Were Incomplete

The next step in the permitting process was the phase one application. Phase one applications served as a high-level overview of the dispensaries’ qualifications. According to City Code Chapter 5.150, the “phase one application shall be signed by one or more management members under penalty of perjury and shall set forth in writing” the following:

- Description of the dispensary identifying its collective or cooperative structure along with its organizing documents;
- Management and applicants’ information;
- Criminal background information of management and applicants;
- Dispensary information such as the number of employees and members;
- Plan of operation that describes how the dispensaries will operate in a manner consistent with state law;
- Statement of plans to operate in compliance with the Planning and Development Code and applicable taxes; and
- Consent from the property owner to operate as a dispensary at the current location.

We assessed phase one application documentation to determine if the Revenue Division performed a sufficient review of phase one applications. Of the 39 “registered” dispensaries, there were 34 dispensaries approved for the phase one application process. Our review of the applications that were approved for phase one found that five dispensary applications did not contain all required documentation for review. For example, *California Naturopathic Agricultural Association’s* application was approved but did not contain all required documents such as description of entity, organization documents, or plans of operation.

We inquired about the five registered dispensaries that were not approved for phase one to assess the reasonableness of their denials, if applicable. One application was denied because the applicant did not pay the application fee or submit a completed application. Our review of the other four registered dispensaries found that they did not submit their phase one applications.

We determined that the Revenue Division’s application review process appeared to be consistent in identifying the applicants that paid the application fee. However, the Revenue Division did not obtain or retain all documentation required for the phase one application. The Revenue Division should have requested and retained all documents required for phase one to demonstrate their due diligence and perform an adequate review to identify unqualified dispensaries.

The Revenue Division's Medical Marijuana Phase Two Records Were Incomplete

The phase two application required a more comprehensive description of dispensary operations to ensure the dispensaries followed the rules outlined in City Code Chapter 5.150 and Chapter 17.228. The approval of phase two applications signified that the dispensaries would receive their medical marijuana dispensary permits. It is important to note that the City placed an administrative hold on processing phase two applications in October 2011 due to concerns regarding the uncertainty over the future of Federal marijuana laws. During this time, the U.S. Attorney's office also commenced enforcement activities on medical marijuana dispensaries. The City's Revenue Division reported that property owners of the dispensaries received enforcement letters demanding that they discontinue the distribution of marijuana from the properties or face criminal and/or civil sanctions. The Revenue Division indicated that some dispensaries were closed due to Federal enforcement. In the Fall 2013, the City removed the administrative hold and proceeded with the phase two application process.

According to City Code Chapter 5.150 the dispensaries "shall...file a phase two application with the city manager's office, that includes the following":

- Security plan prepared by a professional detailing measures to ensure safety and security of the dispensary;
- Floor plan prepared by a licensed civil engineer or architect;
- Site plan prepared by a licensed civil engineer or architect;
- Accessibility evaluation;
- Neighborhood context map depicting boundaries of the dispensary;
- Lighting plan that provides adequate security lighting;
- CUP;
- Commercial general liability insurance policy;
- Annual operating budget;
- Recent year's financial statements and tax return;
- List of products and prices;
- Applicant's certification; and
- Other information such as a "complete application".

To assess whether the Revenue Division issued dispensary permits to qualified dispensaries, we reviewed the phase two applications. Of the thirty approved applications, 25 applications did not contain all required documentation. For example, *Abatin Wellness Center's* application did not contain proof of commercial liability insurance, while *Florin Wellness Center Inc.'s* application contained insurance coverage for a different address than the one indicated on their application.

We also inquired about the dispensaries that did not proceed from phase one to phase two, to determine whether the Revenue Division's denial of the applications was reasonable, if applicable. The Revenue Division's records showed that one dispensary's phase two application was incomplete because it did not apply for the CUP timely; therefore, the dispensary did not obtain a permit. The other

three dispensaries did not submit their phase two applications. We found the Revenue Division's decision to mark an application incomplete for not submitting a CUP application timely was appropriate.

Based on our review, the Revenue Division did not obtain or retain all required documentation for phase two applications. As a result, the Revenue Division could not prove all approved dispensaries complied with documentation requirements outlined in the City Code.

The Revenue Division's 2016 Medical Marijuana Dispensary Permit Renewal Records Were Incomplete

The thirty dispensaries currently licensed to sell medical marijuana in the City are required to renew their dispensary permits annually. Renewal applications are part of an annual review process designed to ensure dispensaries continue to operate in accordance with State law and City Code. The following documents are required to be submitted along with the medical marijuana dispensary renewal application:

- Commercial liability insurance;
- Annual budget for operation;
- Most recent year's financial statements and tax return;
- List of all products and prices; and
- Updated security plan, accessibility evaluation, site plan, floor plan, lighting plan, and neighborhood context map, as applicable.

We reviewed the 2016 applications to assess whether the Revenue Division's application renewal process is effective in renewing permits only to qualified applicants. We found that out of the 30 approved applications, 18 applications did not contain all required documentation for review. Thirteen of those applications did not contain financial statements, six did not contain the recent year's tax return, five did not contain an annual budget of operations, and two did not contain proof of insurance. Specifically, we found that *Sacramento Community Cannabis Collective's* application contained financial statements for two months of 2016, instead of the previous year's end (2015), as requested. Additionally, *Safe Accessible Solutions* and *P.S.A.C. Inc.* applications contained tax extensions rather than their most recent tax returns. As discussed in Finding 1, financial documents provide insight into the dispensaries' financial activities and discrepancies, and such missing documents are red flags that may indicate potential underreporting of gross receipts. Despite the use of a checklist to track documents submitted during the renewal process, we found the Revenue Division still did not obtain or retain all required documentation. Because the City requires these documents be collected as evidence of the dispensaries' qualifications to obtain dispensary permits, the Revenue Division should review the renewal applications for completeness. Based on the information we reviewed, it does not appear that the Revenue Division is adequately documenting their review of applications, and does not obtain or retain complete files for qualified dispensaries.

As mentioned previously, complete and sufficient review of the applications helps the City make informed decisions and provides assurance that only qualified applicants are operating licensed medical

marijuana dispensaries. Based on the documentation retained by the Revenue Division during the application and renewal phases, there was not sufficient evidence in the applications to show that all dispensaries met the requirements outlined in the City Code. The Revenue Division should obtain and retain all required documents to demonstrate adequate assessment applicants qualify for a dispensary permit. We recommend the Revenue Division strengthen controls over the permit renewal approval process to ensure only qualified applicants are approved. The controls should identify the types of documents required, the types of information that should be reviewed, and a process to ensure proper retention of such documents.

RECOMMENDATION

We recommend the Revenue Division:

19. Strengthen controls over the permit renewal application approval process to ensure that all required documentation is obtained and retained for all applicants.

The Revenue Division Could Better Document Dispensary Managing Member, Location, and Entity Name Changes

In November 2010, the City adopted Ordinance 2010-37, which added Chapter 5.150 to Title 5 of the Sacramento City Code. The Ordinance stated that “[a] dispensary shall not transfer ownership or management control of a dispensary or transfer a dispensary permit to another person.” The City began accepting phase one applications in early 2011 with the expectation of finalizing phase two and permitting the medical marijuana dispensaries by January 2012. However, due to uncertainty with Federal laws regarding medical marijuana, the City placed an administrative hold on phase two for two years, effectively halting the process. In the Fall of 2013 the City lifted the administrative pause and allowed the dispensaries to continue the process of applying for phase two. During this time, several dispensaries made changes to their managing members. According to the Revenue Division, as a general rule, the Revenue Division processed applications by tying ownership to at least one owner or principal listed on the previous application.

In February 2016, the Revenue Division acknowledged in its report to Council that “[current] City Code does not allow dispensaries to relocate or change management members...It is not practical to require a dispensary to keep its officers and manager static. The City should not allow the entity to change in its entirety, however employees, managers, and officers will need to change on occasion and City Code should reflect this reality.” Specifically, the Revenue Division Manager, in response to a Council member’s question, clarified that “[when] a dispensary wanted to change their managers, or they wanted to change their name, or they wanted to change where their location was before they actually got their permit, we would look for some continuity. If they wanted to change everything at once, that wasn’t allowed, because obviously, that was new people running a new dispensary somewhere else. So, we’ve always looked for continuity on the board, the managers, [and] the original application. And, we look for a continuity trail along the way with the permit applications.”

Ultimately, City Code section 5.150.210 B was modified as follows:

~~A dispensary shall not transfer ownership or management control of a dispensary or transfer a dispensary permit~~ may not be transferred, sold, assigned, or bequeathed to another person.

While the City Code clarified the prohibition of transfer of a dispensary permit, it was unclear what changes were allowed during the application process. The Office of the City Auditor inquired with the Revenue Division Manager about the changes that were permissible between the initial registration, phase one and phase two applications. On August 31, 2017, the Revenue Division clarified that the medical marijuana applications could contain changes to managing members, location, and dispensary name separately, but not simultaneously. We relied on the Revenue Division Manager's statement to establish criteria for our review as there is no formal procedure specifying the types of changes that were acceptable during the application process.

City Code Chapter 5.150 established medical marijuana dispensary permit approval authority and stated that "[upon] receiving the phase two application, the city manager shall determine whether the application is complete. If the city manager determines that the application is incomplete or has been completed improperly, the city manager shall notify the applicant." The Code stated, "[after] the phase two application is complete, as specified in Section 5.150.070(B) (5), the city manager shall either grant or deny a dispensary permit..." The Code specified that "'[city] manager' means the city manager or its designee," and Revenue Division Manager was selected to administer the medical marijuana dispensary application process. As a result, the Code established discretion for the City Manager in determining the completeness of an application and ultimately in approving or denying a permit.

We reviewed the medical marijuana permit applications to assess the documentation used to support the approval process. We compared documentation between the initial registration, phase one, and phase two applications to verify medical marijuana permits were approved by allowing board member, location, and dispensary name changes separately, but not simultaneously.

During our review, the Revenue Division provided documents that establish continuity. However, in our opinion, the evidence accepted by the Revenue Division could have been stronger. We found the following:

- Two dispensaries' documents of change in organizational leadership were unsigned by appropriate parties.
- One dispensary's evidence of continuity consisted of a handwritten note that, in addition to being unsigned, did not indicate who wrote the note.

In our opinion, the evidence could have been stronger if the department documented how it had authenticated the documents and/or obtained signatures from the parties involved. Since it is likely that

over time, management members, locations, and entity names will change, the City should consider how to strengthen its documentation of its approval process.

Based on the information we reviewed, we believe that the Revenue Division could have gathered better written evidence to support its review and approval process. The reliance on the Revenue Division Manager's recall of events supporting continuity is not advisable. If desirable information, such as minutes approved by the board were not obtainable, the Revenue Division could strengthen the documentation of the decision-making process by making a note to the file detailing the approval process used to accept a disclosed change. Adequate documentation will be important as the City moves towards permitting cultivation, delivery, and adult use. We recommend the Revenue Division define and communicate to the dispensaries the documents needed to support changes to dispensary management members, location, and entity name changes.

RECOMMENDATION

We recommend the Revenue Division:


20. Define and communicate to the dispensaries the documents needed to substantiate changes to dispensary management members, location, and entity name changes.

MEMORANDUM

DATE: September 22, 2017

TO: Jorge Oseguera, City Auditor

FROM: Leyne Milstein, Finance Director



CC: Howard Chan, City Manger
Arturo Sanchez, Assistant City Manager
Ryan DeVore, Community Development Director
Brad Wasson, Revenue Manager

SUBJECT: Department Response to Audit of the City's Medical Marijuana Dispensaries

Thank you for the opportunity to respond to the Audit of the City's Medical Marijuana Dispensaries. Implementation of the City Council's desire to allow medical marijuana dispensaries to operate in the city was a very challenging task. From the initial request in June of 2009 through today, the environment has been ever changing. Many legal, political, financial, and administrative challenges faced the dispensaries and the City along the way and many continue to this day. Consequently, I also appreciate the difficulty of performing an audit on this complex, unpredictable, and dynamic subject. Your staff were very respectful while conducting the audit.

In 2009, the City embarked on uncharted waters in its effort to regulate an industry that once was entirely underground and still was in a legal grey area in many ways. Although medical marijuana had been decriminalized by the state of California, marijuana remained an illegal substance under federal law. As a result, existing dispensaries were operated without the formalities that are usually the hallmark of a normal business (corporate documents, licenses, permits, insurance, contracts, tax filings, etc.) and could not use many of the professional services used by a normal business (accountants and lawyers would not advise them, banks would not safeguard their money, etc.). Consequently, many dispensaries did not have many of the documents listed in the City Code available to provide in their applications. In addition, laws were continually changing and often included substantial ambiguities, litigation ensued throughout the industry, and the threat of criminal prosecution against everyone involved—industry workers, medical marijuana patients, and government officials alike—was palpable.

Despite those challenges, the City lead the charge to create regulations for this emerging industry to protect the health, safety, and welfare of the public. The City did its best to accommodate the needs of the medical marijuana patients to access their medicine, the operations of the established medical marijuana dispensaries,

Finance Administration
PH: 916-808-5845
Fax: 916-808-5755
915 I Street, 5th Floor
Sacramento, CA 95814

and the safety and security of the other businesses and residents of the city. Throughout the process, staff has worked closely with the Office of the City Attorney to implement policies and adjust its regulations to the many challenges it faced. Staff was always conscious of the need to properly administer the City's program and operate within the law.

In hindsight, we have realized several ways in which we can improve our processes and practices relative to the management and administration of this program and associated revenues. In addition, we anticipate that the administration of the city's programs will improve because the recent comprehensive state legislation has triggered the complete transformation of the industry. It is in that spirit, we concur with the auditor's findings and will implement the recommendations presented. In fact, some of those recommendations have already been implemented prior to this report. Attached is a timeline/status report reflecting the current efforts relative to these recommendations. This will be updated quarterly and provided to your office.

Since dispensary permits were issued two years ago, we have improved and expanded our regulations, conducted audits of the dispensaries, and increased enforcement efforts. In 2016, the City brought together a team of employees across all departments to focus on the regulation of the marijuana industry. And in May of 2017, the Finance Department created a new division of Cannabis Policy and Enforcement with 3 new positions to coordinate our efforts.

The City is now in a better position to continue its progress because it has a wealth of experience and reflection to draw upon, but many challenges remain. The legal landscape is still uncertain because marijuana is still illegal under federal law, audits of the industry are still labor intensive because the industry still cannot access banks, and sufficient oversight and enforcement of the city's regulations must continue to be a priority.

TIMELINE FOR AUDIT RECOMMENDATIONS FOR CITY'S MEDICAL MARIJUANA DISPENSARIES

ID	Description	Addressed By	Projected Timeline of Implementation and/or Completion ¹	Status
1	Determine why dispensaries failed to produce the requested financial and membership documentation and inspect the documentation for compliance with City Code.	Revenue	Fall 2017 (ongoing)	Inform those dispensaries who failed to produce requested documents in original audit that further inspection of compliance will occur in future audits and penalties assessed for non-compliance.
2	Consider imposing penalties to encourage compliance with document requests.	Office of Cannabis	Fall 2017 (ongoing)	Ability to assess penalties for non-compliance in City Code. Implementation in progress.
3	Develop a robust review process of the dispensaries' financial statements during the permit renewal process to identify red flags that may indicate potential underreporting of gross receipts.	Revenue	Fall 2017 (ongoing)	In progress of working on comprehensive plan for auditing dispensaries' financial statements and potential for underreporting gross receipts.
4	Perform observation tests of dispensaries to identify underreporting of gross receipts.	Revenue	Fall 2017 (ongoing)	In progress of scheduling a meeting with MuniServices to discuss and review options.
5	Consider collecting monies owed from the dispensaries that underreport gross receipts.	Revenue	Fall 2017 (ongoing)	Revenue Division has already collected monies from dispensaries who were found to have underreported gross receipts in the MuniServices' audit. Other mechanisms for determining underreporting being developed.
6	Develop controls to ensure dispensaries' gross receipts are recorded monthly.	Revenue	Fall 2017 (ongoing)	Implemented and in progress.
7	Establish a process to reconcile payments owed and payments received.	Revenue	Fall 2017 (ongoing)	Revenue staff will complete a detailed reconciliation from July 2011 through current fiscal year. This is included in comprehensive plan for Business Tax collection for ongoing reconciliation. Will communicate changes to dispensaries.
8	Implement controls to ensure complete reviews of MuniServices audit reports.	Revenue	Fall 2017 (ongoing)	In progress. Both Office of Cannabis and Revenue to review audit findings to ensure compliance and follow-up.
9	Review and address MuniServices' audit findings regarding <i>River City Phoenix</i> .	Office of Cannabis	Summer 2017 (ongoing)	Cannabis Policy & Enforcement staff met with owners of River City Phoenix (7/26/17) and addressed findings of MuniServices audit, advising them to ensure they only purchase from collective members and keep detailed records of those transactions.
10	Reevaluate the frequency of MuniServices audits to ensure appropriate coverage of the medical marijuana dispensaries in a timely manner.	Office of Cannabis	Fall 2017 (ongoing)	In progress. Will meet with MuniServices to evaluate the timeliness of audits.
11	Assess the hours spent on dispensary inspections to determine whether CDD has adequate or excess resources.	CDD/Office of Cannabis	Winter 2017 (ongoing)	Cannabis Policy & Enforcement is currently developing a comprehensive inspection and enforcement plan. Inspection protocol is currently in draft form, additional staff for inspections are currently being hired.

ID	Description	Addressed By	Projected Timeline of Implementation and/or Completion ¹	Status
12	Develop, and memorialize in a policy, a risk-based enforcement program that identifies high risk violations, and implement a follow-up process to ensure violations are resolved in a timely manner.	CDD/Office of Cannabis	Winter 2017 (ongoing)	Cannabis Policy & Enforcement is currently developing a comprehensive inspection and enforcement plan. Inspection protocol is currently in draft form, additional staff for inspections are currently being hired.
13	Consider imposing penalties to encourage timely compliance with City Code.	CDD/Office of Cannabis	Fall 2017 (ongoing)	Cannabis Policy & Enforcement is currently developing a comprehensive inspection and enforcement plan. Inspection protocol is currently in draft form, additional staff for inspections are currently being hired.
14	Engage the Office of the City Auditor to perform inspections at the <i>All About Wellness</i> dispensary to assess whether the dispensary is complying with City Code and State laws.	Office of Cannabis	Fall 2017	Notify dispensary and set up time for auditor's visit.
15	Reevaluate the language in the City Code, and if necessary, strengthen the Code to make it clear that the City has the legal right to enter and inspect dispensaries' property and financial records.	Office of Cannabis	Winter 2017 (ongoing)	Work with City Auditor to evaluate City Code. Notify all dispensaries of the City's legal right to enter and inspect.
16	Review and update the dispensaries operating requirements to ensure consistent enforcement practices.	Office of Cannabis/CDD	Winter 2017 (ongoing)	In progress.
17	Reevaluate and clarify City Code regarding the timeframe associated with discontinuance of use.	Office of Cannabis	Fall 2017	Implemented. Confirmed 90 days non-operational for Business Operating Permit and 30 days non-operational for Conditional Use Permit.
18	Follow up on <i>Community Health Solutions</i> to determine if the dispensary is operating.	Office of Cannabis	Summer 2017	Implemented. Confirmed with dispensary that they are open on a limited basis.
19	Strengthen controls over the permit renewal application approval process to ensure that all required documentation is obtained and retained for all applicants.	Office of Cannabis	Summer 2017 (ongoing)	Implemented. Set up permit application process in Accela. Database allows for content management and workflow approval process to ensure department reviewers sign off before permit issuance.
20	Define and communicate to the dispensaries the documents needed to substantiate changes to dispensary management members, location, and entity name changes.	Office of Cannabis	Fall 2017 (ongoing)	A mandatory meeting will be scheduled to communicate requirements to the dispensaries. Either the owner or a manager must be present. The meeting will be followed up with a summary of requirements and information will be sent via certified mail.

¹ Once processes, policies, and reports have been developed the Revenue Division will monitor dispensaries for compliance on an ongoing basis.