November 4, 2021

In keeping with generally accepted government auditing standards and Auditor’s Office policy, as authorized by city ordinance, the Audit Services Division has a responsibility to monitor and follow up on audit recommendations to ensure city agencies address audit findings through appropriate corrective action and to aid us in planning future audits.

In our follow-up effort for the “Marijuana Taxation” audit report issued in April 2020, we determined the Treasury Division fully implemented four of the 10 recommendations it agreed to in the original audit report. It partially implemented two and did not implement four. Although Treasury officials disagreed with one other recommendation, we learned they did take some action to address the concerns.

Overall, despite Treasury's efforts, we determined the risks associated with the audit team's initial findings have not been fully mitigated. As a result, the Audit Services Division may revisit these risk areas in future audits to ensure the city takes appropriate corrective action.

The Highlights page in this report provides background and summary information about the original audit and the completed follow-up effort. Following the Highlights page is a detailed implementation status update for each recommendation.

I would like to express our sincere appreciation to the Treasury personnel who assisted us throughout the audit and the follow-up process. For any questions, please feel free to contact me at 720-913-5000.

Denver Auditor's Office

Timothy M. O'Brien, CPA
Auditor
Objective
To assess the effectiveness and efficiency of the Treasury Division’s audit unit in conducting marijuana tax audits. Our assessment of effectiveness looked at how well the audit unit is achieving its objectives and meeting its goals, while our assessment of efficiency looked at the extent of resources required by the audit unit to produce marijuana tax audits.

Background
The city’s Treasury Division within the Department of Finance is responsible for collecting, recording, and depositing all City and County of Denver taxes and other city revenues. Further, Treasury also ensures compliance with all applicable tax laws.

The audit unit is the largest unit within Treasury and performs audits for Denver’s six excise taxes — as well as the business personal property tax.

The Treasury Division’s Audit Unit Was Not Effective or Efficient at Ensuring All Marijuana Taxes Were Reported and Paid

- Treasury’s audit unit did not use quality information to select marijuana businesses, which impacted how effective it was in identifying businesses with the highest risk of underreporting.
- Treasury’s audit unit did not use — or retain — all relevant information when conducting audits of marijuana businesses.
- Treasury’s audit unit did not adequately measure how efficiently it deployed city resources.
- Treasury’s audit unit had an ineffective process to identify unlicensed marijuana businesses.
- The audit unit’s lack of verification of state shareback payments might have led to a loss of revenue for the city or a liability to the state.

WHY THIS MATTERS
The role of the Treasury Division’s audit unit is critical because it reduces the risk of taxpayer noncompliance and ensures all taxes owed to the city are properly reported and paid.

Using quality information to select marijuana businesses for audit can greatly increase the division’s effectiveness in identifying businesses with the highest risk of underreporting. This can also help the city better achieve revenue targets by retaining relevant information, strengthening processes, measuring resource usage, and verifying state shareback payments.
Nov. 4, 2021

Action Since Audit Report
Marijuana Taxation

11 recommendations proposed in April 2020

The Treasury Division fully implemented four recommendations made in the original audit report, but seven others have yet to be fully implemented or acted upon.

Treasury developed a formal policy and procedure to validate data, ensuring it is accurate and appropriate for decision-making processes. The audit unit implemented measures to coordinate with the state Department of Revenue to receive state audit information to better inform which entities the city selects to audit.

The audit unit did not adopt professional auditing standards as originally recommended. Instead, it implemented policies and procedures requiring the use of relevant information and supervisory review — in addition to developing safeguards to ensure procedures are followed, which results in higher quality and more effective audits. The audit unit took steps to proactively identify unlicensed marijuana delivery businesses and implemented a verification process to check the accuracy of state marijuana shareback payments.

However, several risks remain. By not developing a data-driven approach to audit selection, Treasury risks taxpayer funds being spent on audits that may not recover as much tax revenue for the city as they could.

By not developing a policy to retain supporting documentation, Treasury hinders the verification of tax audit work and the accuracy of audit assessments. Outside auditors, peer reviewers, and others who conduct a peer review or inspection of the division’s audits would not be able to review the documentation and understand how the evidence supports the findings or whether it sufficiently supports the conclusions in the audit.

Furthermore, Treasury did not sufficiently define policy terms, such as what constitutes an “abnormal” or “erratic” trend, or develop appropriate performance measures for marijuana tax audits, inhibiting its ability to efficiently identify these issues. Treasury also did not take adequate steps to coordinate with the Department of Excise and Licenses to review information at the state level.
### FINDING 1 | The Treasury Division’s Audit Unit Is Not Effective or Efficient at Ensuring All Marijuana Taxes Are Reported and Paid

**Recommendation 1.1**

**DEVELOP DATA-DRIVEN APPROACH TO AUDIT SELECTION** – The Treasury Division’s director of tax compliance should develop a data-driven approach to monitor and identify marijuana businesses with a high risk of underreporting. The data-driven approach should include:

- Reviewing tax audit results each year to identify risk factors.
- Quantifying the effect each risk factor has on tax audit assessment of the current year’s tax audits.
- Identifying the most powerful model to account for tax audit assessment and selecting cases based on this model.
- Analyzing tax audit results regularly to determine how effective the risk indicators used to select audits were and to determine whether changes are needed.

**AGENCY ACTION**

**Original target date for completion: Aug. 31, 2020**

Treasury officials said they are in the process of contracting for additional functionality in the division’s GenTax software system to increase the analytics capabilities required to implement this recommendation. However, the city’s Technology Services agency is still reviewing the draft contract. As a result, the estimated date of implementation is now the first quarter of 2022.

While the contract is being reviewed, Treasury developed two reports: One report uses data from previously completed audits, and one uses data from audits in progress to assess their level of risk.

This was not the intent of the original recommendation. The intent of the recommendation was for Treasury to review tax audit results to identify risk factors, which would help to find new businesses to audit. In addition, the recommendation was calling for Treasury to analyze audit results regularly and determine the effectiveness of those risk factors when selecting new businesses to audit. Treasury’s two reports look only at audits that are underway or previously completed — they do not identify and use risk factors when determining which businesses to audit.

While Treasury made progress by working to improve data-driven functionalities that will theoretically be present in the upgraded software,
the purpose of this recommendation was to use data to identify new businesses for auditing, not to assess the risk present in businesses Treasury already chose to audit.

As a result, we consider this recommendation not implemented.

Recommendation 1.2

**FORMALIZE AND FOLLOW POLICY TO VALIDATE DATA** – The Treasury Division’s director of tax compliance should develop and use a formal policy that requires data be validated before it is relied upon to select businesses for audit. Further, the director of tax compliance should develop a corresponding procedure that spells out how the data are to be validated, who is to be responsible for the validation, and the frequency of the validation.

**AGENCY ACTION**

*Original target date for completion: Aug. 31, 2020*

We verified that Treasury developed a formal policy and procedure that requires data to be validated before it is relied upon to select businesses for audit. We also verified that these procedures adequately detail how Treasury staff are to perform the data validation process.

Lastly, we confirmed the procedures detailed in the validation process have been implemented and the data used by Treasury to inform the businesses it selects for audit is being validated. Therefore, we consider this recommendation fully implemented.

Recommendation 1.3

**COMMUNICATE WITH THE COLORADO DEPARTMENT OF REVENUE** – The Treasury Division’s director of tax compliance should coordinate with the Colorado Department of Revenue’s Division of Taxation to obtain state tax audit information through an information exchange agreement. This information should be used to:

- Inform the city’s audit selection process.
- Verify sales information reported to the state matches the sales information reported to the city.

**AGENCY ACTION**

*Original target date for completion: Aug. 31, 2020*
By establishing an information exchange agreement, Treasury coordinated with the Colorado Department of Revenue’s Division of Taxation to obtain state tax audit information. Under this agreement, the Treasury Division receives state audit information of marijuana businesses operating within the City and County of Denver.

Treasury received audits the state conducted of marijuana businesses as well as the state’s total revenue collected because of those audits during the three-year period from July 2017 through July 2020. We saw that Treasury used this information to inform which marijuana businesses it selected for audit. As a result, we consider this recommendation fully implemented.

**Recommendation 1.4**

**BETTER DEFINE POLICY AND CREATE DETAILED PROCEDURES** – The Treasury Division’s director of tax compliance should expound on, and formalize, the agency’s current policy, defining exactly what constitutes an “abnormal” and “erratic” payment trend. Further, Treasury’s director of tax compliance should establish written procedures that correspond to the policy, including defining the individual tasks the specialist is to perform, how communication of risks is to be delivered to the audit unit, and the person responsible for receiving the communication from the specialist.

**AGENCY ACTION**

Original target date for completion: Aug. 31, 2020

Treasury gave us a copy of the policy relevant to this recommendation and we found it did not include definitions or descriptions for what constitutes an “abnormal” or “erratic” payment trend.

Clearly defining what an abnormal or erratic payment trend is helps ensure Treasury identifies all businesses with a risk of underreporting tax information. Without clear definitions, there are no procedures to identify marijuana businesses with greater risks of tax noncompliance. As a result, we consider this recommendation not implemented.

**Recommendation 1.5**

**ADOPT AUDIT STANDARDS** – The Treasury Division’s director of tax compliance should adopt professional audit standards to inform how the audit unit performs its marijuana tax audits. Standards such as those set by the American Institute of Certified Public Accountants, the U.S. Government Accountability Office, and The Institute of Internal Auditors would ensure quality information and relevant information, such as Metrc waste reports,
are used to support audit assessments. Compliance with standards would also ensure there is evidence audit work was properly reviewed.

**AGENCY ACTION**

**Original target date for completion: Aug. 31, 2020**

Treasury’s audit unit developed and adopted its own custom set of standards for the tax audits it performs. The new standards were distributed to division staff during a meeting on Sept. 23, 2020 — nearly a month after the agreed-upon implementation date.

Staff in the audit unit said they preferred to create their own standards rather than adopt preexisting standards because the audit work they perform is narrower in scope than standards issued by the larger governing bodies.

The audit unit also developed an audit checklist to be completed with each audit. The checklist provides step-by-step procedures for completing an audit — including what supporting documentation should be referenced to complete the step as well as indications for what work has been reviewed.

While the audit unit did not adopt the authoritative standards we recommended, the audit unit’s standards do specifically require work to be reviewed and for staff to adhere to policies and procedures during the audit process. The audit checklist addresses the second part of our recommendation, that the audit unit use complete and relevant information and review all audit work.

The audit unit’s actions address significant risks of the recommendation. But the unit fell short of adopting authoritative, comprehensive standards as required by the recommendation. Therefore, we consider this recommendation to be partially implemented.

**Recommendation 1.6**

**RETAIN SUPPORTING DOCUMENTATION FOR TAX AUDITS** — The Treasury Division’s director of tax compliance should update Treasury’s policy for tax audits to require tax auditors to retain supporting documentation in the tax audit files that would provide a clear explanation of any tax adjustments and conclusions made as a result of the audit. This information should be obtained and retained in the audit file as supporting workpapers and could include items such as sales journals, invoices, and other pertinent information. This supporting documentation should be kept for a period of six years after the completion of the audit.
AGENCY ACTION

Despite disagreeing with this recommendation in the original audit report, we learned Treasury did take action to attempt to implement this recommendation. Specifically, Treasury made adjustments to the audit workpaper templates included in its audit files and added a step to its audit checklist, also included in its audit files, that now require auditors to indicate the sources used. This provides more detailed explanations of any tax adjustments and conclusions made as a result of the audit.

However, Treasury would have to do more to fully address the risks this recommendation sought to mitigate. An indication in the audit file of the sources used to explain tax adjustments and conclusions is not equivalent to retaining proper documentation, which was specifically what the recommendation called for. The original audit report identified the following risks:

- Treasury does not retain documentation in its audit files that support the amount of tax assessment — specifically, the number of sales Treasury is using to calculate its assessment. This information is used to determine whether a business underreported sales or underpaid city taxes.
- When auditors do not indicate what information was used to perform the audit or retain the supporting documentation, supervisors are unable to completely verify the work and the accuracy of the audit assessment. As a result, the audit assessment may be over- or understated.
- An experienced auditor who conducts a peer review or an inspection would not be able to review the documentation and understand how the evidence supported the findings or whether it sufficiently supported the conclusions in the audit.

Treasury's efforts of adding a checklist and documenting the sources used do not mitigate these risks.

This was Treasury's response in the original audit:

The Treasury Division respectfully disagrees with this recommendation. The records reviewed in our audits are provided in multiple media forms and not always available to copy. They may also be voluminous. Retaining them in our audit files is not practical and not property of the Treasury. Further, these records often contain information considered confidential by the taxpayer and their customers and suppliers. Additionally, taxpayers are not required to allow the Treasury Division to copy and retain these records.
The Treasury Division will, however, develop policies to document specific records that were reviewed and relied upon for audit conclusions.

For the original report, we wrote the following addendum rebutting Treasury's response:

The Treasury Division disagrees with this recommendation — contending that retaining supporting documentation would be voluminous and contain confidential information, and therefore, it would be impractical for them to retain all documentation. However, we are not recommending Treasury retain all documentation used to perform an audit. Rather, we are recommending Treasury retain only the pertinent documentation used to support tax assessments and sales tax reconciliations — items such as sales journals, general ledgers, and Metrc reports.

In today's electronic environment, it is not uncommon for these records to be in an electronic format, which would minimize the burden of retention. Further, the information contained in sales journals, general ledgers, and Metrc reports typically includes sale dates, amounts sold, purchaser, seller, and description of products sold. These are not details considered to be personally identifiable information or confidential.

Retaining supporting documentation provides an audit trail that a reviewer of the work would require to ensure the audit work was performed accurately and with sufficient evidence. Moreover, leading auditing practices require audit workpapers to provide a permanent record of key workpapers that demonstrate the auditing procedures used and the taxpayer data examined. We reviewed tax documentation procedures from five different state taxing authorities, including the state of Colorado, and found they all require supporting documentation to be retained in their audit files. Additionally, we looked at procedures from the Internal Revenue Service and found, like the five states we examined, supporting documentation is also required to be maintained in a tax audit file.

**Recommendation 1.7**

**DEVELOP SAFEGUARDS TO ENSURE PROCEDURES ARE FOLLOWED** – The Treasury Division’s director of tax compliance should develop safeguards to ensure the audit unit’s marijuana tax audit procedures are consistently followed.
AGENCY ACTION

Original target date for completion: Aug. 31, 2020

Treasury designed a checklist of marijuana audit procedures that audit unit staff must perform on marijuana audits. This checklist includes two fields for each item on the checklist: one to show which staff member performed the procedures and a second to show the date when these procedures were performed.

During follow-up, we reviewed marijuana audit tax files and verified the checklist was being used. This checklist serves as a safeguard to ensure the unit’s marijuana tax audit procedures are consistently followed. As a result, we consider this recommendation fully implemented.

Recommendation 1.8

DEVELOP AND MONITOR A COMPREHENSIVE SET OF PERFORMANCE MEASURES – The Treasury Division’s director of tax compliance should develop a comprehensive set of performance measures that address each of the audit unit’s goals and objectives and the different aspects of the services being provided. Further, the performance measures should be monitored closely on a recurring basis to assess the adequacy of results using the following criteria:

- Expected resource use or efficiency level.
- Past performance (trending).
- Performance measurement rates of other units doing similar work.

Lastly, management should interpret the results of performance measurement and take appropriate action where needed.

AGENCY ACTION

Original target date for completion: Aug. 31, 2020

Treasury’s audit unit created several performance dashboards that are kept in a data analytics tool. These dashboards use exported data from GenTax, the city’s tax management software. The dashboards provide useful visualizations of various performance measures — including the average number of days an audit is open, a count of audits by year and by stage, audit hours, revenue to date, and others.

While the data being used is helpful to identify certain unusual data points,
it is not substantially different than the data identified in the original audit report. This data includes:

- The number of audits completed in a year.
- The amount of revenue recovered through audit assessments in a year.
- The length of time to complete audits.

One dashboard created by the audit unit did focus exclusively on marijuana audit reviews but measured only two valuable metrics:

- Charts of taxes, penalties, and interest earned by audit hour.
- Charts of tax dollars collected, by tax type, for a four-year period.

Treasury has not developed a comprehensive set of performance measures that address each of the audit unit’s goals and objectives and the different aspects of the services being provided. The metrics presented in the new performance dashboards are largely the same metrics that were tracked before the recommendation, and the additional metrics implemented are insufficient to address the risk of the recommendation. Therefore, we consider this recommendation not implemented.

**Recommendation 1.9**

IDENTIFY UNLICENSED MARIJUANA DELIVERY BUSINESSES – The Treasury Division’s director of tax compliance should develop policies and procedures for identifying unlicensed marijuana delivery businesses that are not reporting and remitting sales tax. Such procedures could include:

- Setting Google alerts for terms relevant to the marijuana industry and marijuana delivery.
- Checking marijuana businesses advertised on digital platforms such as Weedmaps, Leafly, and WeedAdvisor, and cross-reference those businesses with the city license database.
- Identifying potential unlicensed businesses through the city’s business license complaint system and the Denver 311 program.

**AGENCY ACTION**

Original target date for completion: Aug. 31, 2020

Treasury officials said they implemented this recommendation through revised procedures for the tax specialist position. But we obtained the revised procedures and found no mention of marijuana delivery.

While we did not note any revisions to the actual procedures performed, a new section does require the tax specialist to provide information to the city's Department of Excise and Licenses for any unlicensed businesses that
they identify.

We interviewed the tax specialist who performs the procedures and learned the procedure compares licensed businesses registered with Excise and Licenses to businesses with tax licenses through Treasury. Any discrepancies are reported to Excise and Licenses. However, this procedure identifies only delivery businesses that were licensed with Excise and Licenses but not licensed with Treasury, or vice versa.

The tax specialist also said Google alerts were set up using four phrases, including “Marijuana Delivery, Denver CO.” The specialist said that, on occasion, irregularities have been identified through these alerts and the Excise and Licenses was notified.

The analyst said they also regularly review websites relevant to the marijuana industry for updates on the industry as they relate to Denver. The specialist said they reviewed the digital platforms suggested in the recommendation — Weedmaps, Leafly, and WeedAdvisor — but that information on those platforms was often found to be inaccurate or outdated.

The combination of license cross-references between the Department of Excise and Licenses and the Treasury Division and the creation of Google alerts together serve to adequately address the procedures that were recommended.

However, because the Google alert notifications are not part of the official policies and procedures, it is at risk of being discontinued with any staffing changes. We consider this recommendation only partially implemented.

Recommendation 1.10

COORDINATE WITH THE DEPARTMENT OF EXCISE AND LICENSES – The Treasury Division’s director of tax compliance should coordinate with the Department of Excise and Licenses to obtain relevant reports the division could use to streamline its monthly reconciliation process. The reports should contain the marijuana license reports received from the state, as well as Accela data documenting status updates with city marijuana licenses.

AGENCY ACTION

Original target date for completion: Aug. 31, 2020

Treasury officials said they implemented this recommendation through revised procedures for the tax specialist position. Treasury did add language requiring its tax specialist to forward unlicensed marijuana businesses to Excise and Licenses. However, there is still no policy requiring Treasury to coordinate with Excise and Licenses to obtain the reports mentioned in this
recommendation. Accordingly, our review of the procedures found they were effectively unchanged.

Additionally, we found the processes in place for both reconciliations were still the same manual processes that existed during the original audit. Lastly, staff are not requesting state licensing data as originally recommended.

As a result, we consider this recommendation not implemented.

**Recommendation 1.11**

**DESIGN AND IMPLEMENT VERIFICATION SAFEGUARDS OVER SHAREBACK PAYMENTS** – The Treasury Division’s director of tax compliance and the Controller’s Office should work together to ensure that either the division or the office design and implement safeguards to make sure the monthly state shareback payment is accurate. Such safeguards should include:

- Reconciling amounts reported by the state for sales in Denver to recreational marijuana sales pulled from the city’s GenTax system.
- Recalculating the amount of the shareback payment using amounts reported from the state.
- Comparing the state’s shareback payment received to the amount reported by the state as being owed.

**AGENCY ACTION**

**Original target date for completion: April 30, 2020**

The Department of Finance developed a procedure to address this recommendation. Additionally, we saw evidence that Finance is performing the steps required by its new procedure.

The procedure compares sales according to GenTax with sales according to the state of Colorado, recalculates the amount of the shareback payment, and compares the received shareback payment to the amount reported by the state as being owed to the city. This addresses all key points made in the recommendation. As a result, we consider this recommendation fully implemented.
Office of the Auditor

The Auditor of the City and County of Denver is independently elected by the residents of Denver. He is responsible for examining and evaluating the operations of city agencies and contractors for the purpose of ensuring the proper and efficient use of city resources. He also provides other audit services and information to City Council, the mayor, and the public to improve all aspects of Denver's government.

The Audit Committee is chaired by the Auditor and consists of seven members. The Audit Committee assists the Auditor in his oversight responsibilities regarding the integrity of the city's finances and operations, including the reliability of the city's financial statements. The Audit Committee is structured in a manner that ensures the independent oversight of city operations, thereby enhancing residents' confidence and avoiding any appearance of a conflict of interest.

Our Mission

We deliver independent, transparent, and professional oversight in order to safeguard and improve the public's investment in the City and County of Denver. Our work is performed on behalf of everyone who cares about the city, including its residents, workers, and decision-makers.