AUDIT REPORT
Marijuana Taxation
Finance Department – Treasury Division
April 2020

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Audit Services Division
City and County of Denver

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Cover photo illustration by Denver Auditor’s Office staff.
April 16, 2020

AUDITOR’S LETTER

The objective of our audit of the City and County of Denver's marijuana taxation was 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 amount of resources required by the audit unit to produce marijuana tax audits. I am pleased to present the results of this audit.

The audit revealed Treasury's operations over its audit unit have led to an ineffective and inefficient use of city resources. The audit found gaps in agency-level practices that include: relying on faulty assumptions and inaccurate data when selecting which marijuana businesses to audit, not using relevant and sufficient information when performing its marijuana sales tax audits, not communicating with the state to obtain relevant information when performing tax audits, and a lack of structure related to how the audit unit uses its marijuana industry-dedicated tax technician specialist. Such risks could lead to a loss in marijuana tax revenue for the city, which then could mean less funding for services to Denver residents.

Through a stronger set of internal controls and a more systematic approach to evaluating marijuana businesses, the audit unit could more effectively identify and select marijuana tax audits, conduct more impactful marijuana tax audits while efficiently using resources, and generate more marijuana tax revenue. Our report lists several related recommendations.

This performance audit is authorized pursuant to the City and County of Denver Charter, Article V, Part 2, Section 1, “General Powers and Duties of Auditor,” and was conducted in accordance with generally accepted government auditing standards. Those standards require 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 the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

We extend our appreciation to personnel within the Treasury Division who assisted and cooperated with us during the audit. For any questions, please feel free to contact me at 720-913-5000.

Denver Auditor's Office

Timothy M. O’Brien, CPA
Auditor
Marijuana Taxation
April 2020

Objective
The objective of our audit was 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 — the sales tax, use tax, occupational privilege tax, lodger’s tax, facilities development admissions tax, and telecommunications business tax — as well as the business personal property tax.

REPORT HIGHLIGHTS

Highlights from Audit
The Treasury Division’s Audit Unit Is Not Effective or Efficient at Ensuring All Marijuana Taxes Are Reported and Paid

- Treasury’s audit unit does not use quality information to select marijuana businesses, which impacts how effective it is in identifying businesses with the highest risk of underreporting.
- Treasury’s audit unit does not use — or retain — all relevant information when conducting audits of marijuana businesses.
- Treasury’s audit unit does not adequately measure how efficiently it deploys city resources.
- Treasury’s audit unit has an ineffective process to identify unlicensed marijuana businesses.
- The audit unit’s lack of verification of state shareback payments may lead to a loss of revenue for the city or a liability to the state.
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BACKGROUND

**Treasury Division**

The city’s Treasury Division within the Department of Finance is made up of two sections: the Tax Compliance Section and the Denver Motor Vehicle Section. The largest is Tax Compliance, which has two overarching goals: 1) to ensure taxpayers properly report all taxes owed to the city and 2) to collect all taxes reported to the city. The Tax Compliance Section is further broken down into units, including the operations unit, collections unit, and the audit unit. The focus of this audit is on the audit unit and the role of the collections unit's tax technician specialist.

The audit unit plays a key role in meeting Tax Compliance's two primary goals of ensuring reporting of taxes and the collection of taxes, with the unit's employees representing about one-half of the overall staff resources within the Tax Compliance Section. In 2019, the audit unit had 46 full-time positions dedicated to performing or supporting tax audits.

The unit functions as the city’s primary mechanism for detecting and deterring noncompliance with city sales tax ordinances through sales tax audits, which involve the review of a business's financial records to identify any underreported or unremitted taxes it should have paid the city. If a tax audit finds a business did not report or pay all taxes owed, the business must pay the city an assessment that is the amount owed plus any penalties and interest.

**City and State Sales Taxes**

**City Sales Tax** – According to city ordinance, every retailer shall be liable and responsible for paying 4.31% of taxable sales of tangible personal property or services specified in the ordinance.¹ This sales tax applies to both medical and recreational marijuana.

**City Recreational Marijuana Sales Tax** – In addition to the 4.31% city sales tax, recreational marijuana also has additional special sales tax rates applied to it. Specifically, city ordinance adds both a 3.5% special sales tax and an additional 2% special sales tax on recreational marijuana products.² The 3.5% special tax is credited to the city's general fund, and the 2% special tax is credited to the city's Affordable Housing Property Tax Revenue Fund to be used for affordable housing projects.

Figure 1 on the following page provides a breakdown of both medical marijuana and recreational marijuana sales taxes, showing how the total sales tax rate for each is allocated to the city's specific funds.

City Tax Returns and Tax Remittance – City ordinance requires all retailers to file a sales tax return with the Treasury Division on or before the 20th day of each month for the preceding calendar month and remit simultaneously the total amount owed to the city.¹

State of Colorado Taxes – In addition to city sales taxes for marijuana, businesses must also pay state marijuana taxes. The state imposes a 15% marijuana sales tax for recreational marijuana and a standard 2.9% state sales tax for medical marijuana.

Shareback of Colorado State Taxes on Recreational Marijuana – The state provides a “shareback” of state sales tax revenue to local jurisdictions that have chosen to sell recreational marijuana. Each jurisdiction receives 10% of the revenue collected from the state's 15% sales tax on recreational marijuana sales occurring within their jurisdiction.

For example, assume the city of Denver sold $30 million in recreational marijuana in a given month. Further, assume that total recreational marijuana sales across the state totaled $100 million. As a result, the state of Colorado would have collected $15 million in sales tax (15% x $100 million). Because Denver’s recreational sales accounted for 30% of the state’s recreational marijuana sales ($30 million ÷ $100 million = 0.30), the city would receive a shareback payment of about $450,000 ($15 million x 10% x 30% = $450,000).

As set forth in state law, shareback distributions are made monthly, no later than the 15th day of the second successive month after the month in which recreational marijuana sales taxes were collected.⁴

**FIGURE 2.** Denver’s Share of Colorado’s Marijuana Shareback Payment Over Time

![Bar chart showing Denver's share of shareback payments from 2014 to 2019.](Image)

*Source:* Graphic designed by Auditor’s Office staff using information from marijuana tax data reports from the Colorado Department of Revenue’s website.

**City of Denver Tax Information System** – The city uses a software system called GenTax to process tax returns and payments, including sales taxes applicable to medical and recreational marijuana businesses. GenTax is designed to handle information and payments for multiple taxes levied by a government.

**Marijuana Enforcement Tracking Reporting and Compliance System**

Colorado state regulations require marijuana businesses to use a specific inventory-tracking system called the Marijuana Enforcement Tracking Reporting and Compliance system, or Metrc, which provides a seed-to-sale chain of custody for all marijuana products.⁵ Metrc allows the state to track all the marijuana inventory grown, processed, transferred, and ultimately sold for medical or recreational use.

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⁵ 1 Colo. Code Regs. 212-3 § 3-805.
The Metrc system’s goals are to:

- Capture perpetual inventory quantities for each marijuana licensee
- Track and record a chain of custody from "starter" plant to patient or consumer acquisition
- Provide the inspection process with the tools necessary to complete on-site validation of inventory
- Support the auditing process from a series of exception reports
- Provide the industry with the means to report inventory levels

**Marijuana Licensing**

City ordinance requires all recreational and medical marijuana retail establishments to obtain a license before they can operate in Denver. The license requirement is twofold, as all retail establishments — whether recreational or medical — must obtain a license from both the state licensing authority as well as a license from the city.

Figure 3 lists the types of recreational and medical marijuana licenses the city issues.

**FIGURE 3. Recreational and Medical Marijuana Licenses**

<table>
<thead>
<tr>
<th></th>
<th>STORE</th>
<th>CENTER</th>
<th>CULTIVATION</th>
<th>OPTIONAL PREMISES CULTIVATION</th>
<th>INFUSED PRODUCTS MANUFACTURER</th>
<th>TESTING FACILITY</th>
<th>TRANSPORTER</th>
</tr>
</thead>
<tbody>
<tr>
<td>RECREATIONAL</td>
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<td></td>
<td>✗</td>
<td>✗</td>
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<tr>
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<td></td>
<td></td>
<td></td>
<td>✗</td>
<td>+</td>
</tr>
</tbody>
</table>

Source: City and County of Denver Department of Excise and Licenses' website.

**Monitoring Marijuana Businesses at the State and Local Level**

Because marijuana businesses are subject to both city and state taxes, marijuana businesses are subject to tax compliance audits at the state and local level. The city's audit unit uses a risk-based model to select which businesses to audit each year. Risks are identified in three ways:

- Through the audit unit's audit committee;
- Through auditor leads; and
- Through a tax technician specialist position that Treasury has

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7 Denver Revised Municipal Code § 6-206 and 24-503.
8 This is a meeting held twice a year by Treasury consisting of audit unit personnel who meet to select which businesses will be audited.
dedicated to the marijuana industry.

The audit unit’s audit committee selects businesses to audit based on two primary risk indicators: a business’s total tax payment made to the city and its prior audit history. The committee tracks the businesses with the highest total tax remittances paid to the city and selects businesses from this list to audit. Additionally, businesses with a prior audit history may be selected again to be audited.

Auditors also conduct regular research to learn about risks. For instance, an auditor may learn a business did not submit a tax return for several months in a row, which may trigger the auditor to request this business be audited.

Treasury’s dedicated marijuana tax specialist also helps identify which marijuana businesses to audit. According to the specialist’s procedures, an analysis should be conducted to check whether marijuana businesses’ taxable sales reported to the state are equal to those reported to the city. In instances when there are discrepancies between the two numbers, the specialist may refer these businesses to the audit unit.

Meanwhile, the state may also conduct audits of local marijuana businesses. The state’s Taxation, Audit, and Compliance Division is responsible for conducting audits of marijuana businesses to ensure all state taxes are properly reported and paid. The state uses statistical models to analyze tax return and inventory data, and the results are reviewed to identify marijuana businesses with a high risk of underreporting state taxes.

As mentioned previously, all marijuana businesses are required to be licensed at both the state and local level. As such, both the city and the state take measures to identify unlicensed marijuana businesses. Within the city’s Treasury Division, the dedicated tax specialist helps identify unlicensed businesses by performing monthly checks to ensure all marijuana businesses are both recorded in GenTax and that GenTax holds accurate tax license information for each business.

To perform this check, the tax specialist first pulls license information from the city’s license database, Accela. The specialist then verifies the city’s internal systems — GenTax and Accela — both have matching license information for all city marijuana businesses. Next, using the state’s online licensing database, the specialist makes an external comparison by matching the state’s licensing data with licensing data in the GenTax system for each of the city’s marijuana businesses.

At the state level, the Department of Revenue’s Marijuana Enforcement Division is responsible for processing and monitoring marijuana business licenses. The division processes licenses for all marijuana businesses in the state and monitors each licensee to ensure businesses comply with state laws.
FINDING

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

An organization operates effectively when it successfully achieves its stated objectives, and it operates efficiently when it achieves those objectives with a minimum use of resources.\(^9\)

As mentioned, one of the audit unit’s top goals is to reduce the risk of taxpayer noncompliance — either underreporting or not remitting taxes — so that all taxes owed to the city are properly reported and paid. Through this critical role of ensuring taxpayers report and remit all taxes owed, the audit unit’s operations have a direct relationship to achieving the city’s revenue targets and providing revenue to fund services for city residents. Such a vital role requires operations to be performed in an effective and efficient manner.

Our work shows the audit unit does not operate in an effective or efficient manner because of a lack of sound internal controls. These internal controls, or safeguards, are needed to ensure the audit unit achieves its operational objectives — that taxpayers are both reporting and remitting all taxes owed. Each of the issues discussed below touches on different aspects of an entity’s internal controls such as information used to make decisions, clearly and adequately documenting policies and procedures, and monitoring the entity’s performance.

Specifically, we found the audit unit does not use quality information to identify the marijuana businesses with the highest risk of underreporting. The audit unit also does not always use all relevant information when conducting audits of marijuana businesses. Further, the audit unit does not measure, or monitor, a comprehensive set of performance metrics. The audit unit’s process to identify unlicensed businesses can be both more efficient and more effective. Lastly, Treasury does not verify the amount of money it receives from the state’s monthly shareback payment.

According to the federal Government Accountability Office, government entities implement “internal controls” to ensure the organization’s objectives will be achieved.\(^10\) GAO standards break down organizational objectives into three categories: operations, reporting, and compliance. For

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this audit, we focused on the audit unit’s operations objectives, which are defined as how effectively and efficiently an organization achieves its goals and objectives.

According to GAO standards, an organization’s control system must be designed and implemented to ensure its operations meet its objectives in an effective and efficient manner. When a control system is lacking, the organization runs the risk of either not achieving its stated objectives or doing so at the cost of additional resources.

Our work identified several areas in which the audit unit’s audit selection process could incorporate better quality information. The Institute of Internal Auditors defines “quality information” as information that is relevant, reliable, and sufficient.\textsuperscript{11}

In terms of selecting which businesses to audit, “relevant information” includes any source of information to learn about the risks associated with marijuana businesses underreporting tax information. “Reliable information” means the audit selection process uses accurate information to assess the risk of underreporting. And “sufficient information” means the selection process uses enough information to have reasonable assurance a risk of underreporting is likely present.

We found the audit unit does not use all relevant information to ensure the businesses with the highest risk of underreporting are identified. Further, we found the unit’s audit selection process used unreliable information because it did not validate the data used to inform its selection process. Lastly, we found the audit unit could collect sufficient information to inform its selection process by obtaining information from the state and by clearly defining what risks the tax specialist should focus on.

Selecting which businesses to audit is an important process given the limited resources available to the audit unit. Treasury recognizes this importance in its strategic plan.

which states: “It is essential that resources are deployed in the most efficient and productive manner possible.” Therefore, the process the audit unit uses to select which marijuana businesses to audit is important to ensure the city is collecting the greatest amount of tax revenue while using the smallest amount of city resources.

By not using quality information to select which marijuana businesses to audit, the audit unit is not selecting the businesses with the highest risk of underreporting tax information. As a result, the city may be losing out on potential revenue from tax audit assessments, which could mean less funding for services to Denver residents.

The Audit Unit Does Not Use All Relevant Information Available When Selecting Businesses to Audit

We measured the audit unit’s audit selection process against two sources: the state’s Taxation, Audit, and Compliance Division and the Organisation for Economic Co-operation and Development’s Forum on Tax Administration. We selected the state as a comparison entity because it conducts audits of marijuana businesses just like the city. Further, marijuana laws vary by state, and having an audit department performing the exact type of audits under the same state laws makes for a strong point of comparison. We selected the OECD’s Forum on Tax Administration as a comparison because of its reputation as a worldwide leader in best-practice sharing, advice on public policies, and global standard-setting.

We found that both of our comparisons support a data-driven approach to guide tax audit case selection — specifically, using data-driven practices to inform which businesses possess the highest risk of underreporting.

In 2014, the state began quantifying the risks associated with marijuana businesses underreporting to inform its tax audit selection process. While the specifics of the data-driven approach have evolved, state officials explained their process consists of five components, which are summarized in Figure 4 on the following page.

One technique the state has used to identify high-risk businesses is regression analysis. This type of analysis allowed the state to measure the effect the risk indicators had on prior tax audit assessments, which informed the selection process for the current year.

For example: Say that the audit department of city XYZ was trying to estimate how much revenue it can generate next year from tax audit assessments of marijuana businesses in its city. Assume the department knows dozens of variables can impact the estimated revenue — from the

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12 City and County of Denver, Department of Finance Treasury Division, “Tax Compliance Section 2019 Audit Plan.”
13 The Organisation for Economic Co-operation and Development’s Forum on Tax Administration brings together tax administrators from 53 countries. The group’s goal is to enhance tax administration around the world through identification of key features of effective audit activities found in a variety of tax administrations and outline the principles underpinning these characteristics.
Regression analysis is a technique used to estimate the relationship between multiple variables. Specifically, regression analysis shows how much one variable changes when there is a one-unit increase in another variable (e.g., the regression may show that an increase in the amount of time a business has been operating leads to a reduction in the amount of tax information the business underreports). Regression is a way for this hypothetical audit department to mathematically identify which of those variables actually impacts tax assessments. It answers which variables matter the most and which variables can be ignored.\(^\text{14}\)

The state’s data-driven regression approach aligns with the process

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recommended by industry-leading organizations such as the Forum on Tax Administration. According to a report published by this group, the audit selection process can be more effective when administrators apply data-driven practices.\textsuperscript{15} The report includes results from a survey asking how 18 different tax administrations use data-driven practices. Of the 16 tax administrations that submitted responses, 15 reported they use data-driven practices to inform the audit selection process. Specific practices include statistical techniques to predict underreporting, such as regression analysis.

Our testing work showed Treasury’s audit unit operates under several false assumptions regarding the risks associated with marijuana businesses such as:

1. Marijuana businesses are more compliant than nonmarijuana businesses as measured by tax audit assessment amounts;\textsuperscript{16}

2. Total taxes paid is an effective risk indicator; and

3. Prior audit history is an effective risk indicator.

**Marijuana vs. Nonmarijuana Businesses** – Treasury’s audit unit provided us with a report showing the tax audit assessments of marijuana businesses and nonmarijuana businesses for a period covering January 2018 through August 2019. A tax audit assessment is the amount a business underreported plus any penalties and interest. The report included 842 nonmarijuana businesses with an average assessment of $59,932 and 52 marijuana businesses with an average assessment of $28,425.

We performed a t-test to learn whether the difference in average assessments between the two groups supports the audit unit’s claim that marijuana businesses are more compliant than nonmarijuana businesses.

A t-test reveals how significant the difference in tax audit assessment amounts is between the two groups of marijuana businesses and nonmarijuana businesses. In other words, it reveals whether the differences in assessment amounts could have happened merely by chance. Simply comparing the average tax audit assessment amounts between the two groups is not enough. The t-test we performed took it one step further by not only comparing the averages between the two groups but also comparing the variation, or dispersion, within each of the two groups.


\textsuperscript{16} These amounts were reflected in a report Treasury compiled listing tax assessment amounts for marijuana and nonmarijuana businesses.
The results of the t-test showed there is not a statistically significant difference in the average assessments between marijuana businesses and nonmarijuana businesses. These results refute the audit unit's belief that marijuana businesses are more compliant than nonmarijuana businesses.

**Risk Indicators** – During its audit selection process, the audit unit uses two key risk indicators to select businesses: 1) a business's total amount of taxes paid and 2) a business's prior audit history. To test whether these indicators are useful in identifying marijuana businesses that underreport tax information to the city, we performed a correlation test and regression analysis.

Using the tax audit assessments of tax audits completed during January 2018 through October 2019, we found neither risk indicator appears to help predict the level of underreporting by the businesses. Specifically, tax audit assessment has a weak, negative correlation with both the number of times each business has been audited before the most recent tax audit assessment and with the total amount of taxes paid: -0.18 and -0.05, respectively. These values show the two risk indicators of prior audit history and total taxes paid are ineffective at identifying underreporting. This is because correlation values range from negative one to positive one — where a value of positive one means two variables are perfectly related.

Further, the regression results indicate neither prior tax audit history nor total remittance is a statistically significant predictor of tax audit assessments. This means these risk indicators do not effectively predict the level of underreporting by the marijuana businesses included in the data.

The reason for the audit unit's misunderstanding of the risks associated with the marijuana industry is because it lacks a data-driven approach to monitor the risks of the industry. Using a data-driven approach to monitoring risks of the industry would help the audit unit to better understand the extent of risks associated with marijuana businesses. This misunderstanding may result in selecting marijuana businesses without the highest risk of underreporting.

To explore risk indicators not used during the audit unit's tax audit selection process, we created a spreadsheet listing attributes pulled from GenTax for 69 marijuana businesses with recent tax audit assessments. We included attributes such as the business's total sales for two years before the most recent tax audit, the type of marijuana licenses each business had (e.g., medical sales license, medical grow license, etc.), the number of times a business did not make a timely tax payment, the number of times a business made a late tax payment, and the business's payment method.

We used regression analysis to test whether any of these attributes influenced tax audit assessment. For example, the results showed businesses with issues related to the occupational privilege tax have a higher risk of underreporting their tax information. This does not necessarily mean the business is underreporting its occupational privilege tax information as
a tax audit assessment includes underreporting related to sales, use, and occupational privilege taxes.

Results also showed that tax audits conducted of businesses with both medical sales licenses and medical grow licenses have a lower risk of underreporting their tax information. Appendix A lists several other variables that impact underreporting. While these variables help predict underreporting, our recommendation below is for the audit unit to implement its own process to explore risk factors that predict underreporting.

Our results show the audit unit could increase the effectiveness of its process for selecting tax audits through a data-driven approach. With such an approach, the audit unit may be able to better identify businesses with a higher risk of underreporting.

**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; and
- 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 Response: Agree, Implementation Date – Aug. 31, 2020**

**The Audit Unit Used Inaccurate Data from GenTax When Selecting Marijuana Businesses to Audit**

As part of our audit, we performed checks to ensure the Treasury data we used to perform our audit work was accurate and complete. Specifically, we relied on Treasury’s tax assessment amounts and the amount of time taken to perform an audit measured in hours. We used tax assessment data to analyze Treasury’s audit selection process, as discussed on pages 8-12. And we used tax assessment and hours data to analyze Treasury’s efficiency measures, as discussed on pages 25-29. The data we used for each analysis included information for both marijuana and nonmarijuana businesses.
We included nonmarijuana businesses to use as a comparison to measure against marijuana businesses.

Additionally, the tax assessment data we used to perform some audit work is also used by Treasury during its audit selection process. We identified a number of instances when the data we pulled directly from Treasury’s GenTax system contained inaccuracies. Specific inaccuracies in GenTax included incorrect tax audit assessment amounts and incorrect hour totals for the time taken to complete audits.

**Audit Assessment Amounts** – Because the audit unit uses audit assessment amounts to select businesses to audit, we checked the accuracy of the audit assessment amounts for a total of 1,484 tax audit files, which included both marijuana and nonmarijuana businesses.

Of these, 307 (or 21%) contained inaccuracies. The largest single inaccuracy identified was $3.9 million; we found an audit file that showed a total audit assessment amount of $7.8 million, when, in fact, the true assessment amount was only $3.9 million. The inaccuracies were caused by an update to the GenTax system. After the update, if audit unit staff made any changes to the audit file with a final tax assessment, the tax assessment amount increased because the system double-counted the file’s tax assessment. In the aggregate, the total dollar amount of inaccuracies we identified was about $19 million.

As part of the audit unit’s in-house audit committee, the audit unit automatically selects for audit any marijuana business that has been previously audited by the city and that had a tax audit assessment over $100,000.\(^\text{17}\) When mistakes make their way into the data, marijuana businesses can get selected for audit that would not have been selected had reliable data been used.

We reviewed the audit unit’s most recent audit committee list of businesses selected for audit (from June 2019) to see whether the inaccurate data resulted in any businesses being selected that should not have been selected for audit. We identified three of 61 businesses selected for audit that most likely would not have been chosen had the audit unit used accurate data. Relying on inaccurate data resulted in audits being performed on businesses that did not have previous assessments over the $100,000 threshold. Additionally, had we not identified this error in our testing, we found an audit file that showed a total audit assessment amount of $7.8 million, when, in fact, the true assessment amount was only $3.9 million.

\(^\text{17}\) This is a meeting held twice a year by Treasury consisting of audit unit personnel who meet to select which businesses will be audited.
the audit unit may have continued to select businesses to audit based on inaccurate audit assessment data in the future.

By not deploying its scarce resources to audit businesses that pose the highest risk of noncompliance, the audit unit reduced its ability to ensure businesses properly report all taxes owed and that all taxes reported were collected.

U.S. Government Accountability Office standards say management should use quality information to achieve the entity's objectives. Further, these standards state management should process the data obtained into quality information that can be used to make decisions. To be considered “quality,” information used by management should be obtained not only from reliable sources but also be accurate and complete and obtained in a timely manner.

Discussions with the audit unit revealed it lacks formal policies and procedures that require data be validated before management uses it to determine which marijuana businesses should be audited.

**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 Response: Agree, Implementation Date – Aug. 31, 2020**

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The Audit Unit Could Obtain Tax Information from the State to Inform Its Selection Process

We found the audit unit does not communicate with the Colorado Department of Revenue to obtain state tax audit information. U.S. Government Accountability Office standards say management should communicate with and obtain quality information from external parties using established reporting lines. By obtaining taxpayer information from an external party such as the state of Colorado, the audit unit could use what is reported to the state as additional information to inform its audit selection process.

Treasury’s audit unit says it has made no attempt to obtain state tax audit information because of state laws restricting the release of taxpayer data. While state law does restrict the release of taxpayer information, the law also provides for a number of exceptions.

Figure 5 lists the 16 entities specified in state law that can receive state tax or state tax audit information.

**FIGURE 5.** Government and Nongovernment Entities Permitted by State Law to Receive Sales Tax Information and Audit Information

<table>
<thead>
<tr>
<th>LOCAL</th>
<th>STATE OF COLORADO</th>
<th>FEDERAL</th>
</tr>
</thead>
</table>
| • Any county assessor in Colorado in relation to property taxes | • Division of Unemployment Insurance  
• Department of Human Services  
• Department of Corrections  
• State Treasurer  
• Division of Aeronautics  
• State court administrator  
• Legislative Council staff  
• Division of Conservation | • Department of Public Health and Environment  
• Department of Local Affairs  
• Office of Economic Development and International Trade  
• Other state agencies as required  
• Historical Society  
• Property tax administrator | • Internal Revenue Service |

*Source:* Graphic designed by Auditor’s Office staff using information from state law.

Typically, under these exceptions, the state will enter into an information exchange agreement that spells out the responsibilities of the party receiving the confidential information, including how the information must be protected. For instance, Colorado has an agreement with the Internal Revenue Service that allows the state to share state tax audit information with the IRS and vice versa. Although not specified in state law, Treasury could pursue an agreement with the state similar to the one the state has with the IRS. Obtaining state tax audit information would lead to numerous potential benefits for the city, including:

19 Ibid.
• Increasing tax revenue to the city. By using state tax audit reports, the audit unit would have the ability to better determine whether businesses, both marijuana and nonmarijuana, are underreporting on city tax returns. For example, if a state tax audit noted underreporting of sales taxes by a business, the audit unit could use this information to determine whether that same business filed an incorrect sales tax return with the city.

• Increasing the audit unit’s operational efficiency by cutting down on the duplication of effort with marijuana businesses audited by the state. For example, the city could avoid focusing on businesses recently audited by the state that resulted in zero-dollar audit assessments.

• Allowing the audit unit to incorporate state tax audit information into its audit selection process as a risk indicator to help determine which marijuana businesses to select for audit.

Figure 6 shows the number of audits the state conducted of marijuana businesses and nonmarijuana businesses as well as the total revenue collected as a result of those audits during a recent two-year period. For example, from July 2017 through June 2018, the state conducted 52 audits of marijuana businesses resulting in about $1.2 million in tax revenue.

Assuming the city’s audit unit has not already audited these 52 marijuana businesses, the city could use the state audit results to identify underreported sales and unremitted sales tax to the city.

FIGURE 6. Number of Audits and Dollar Value of Assessments from Audits Performed by the Colorado Department of Revenue in the City and County of Denver, July 2017 through June 2019

Source: Information from the Colorado Department of Revenue.
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; and
- Verify sales information reported to the state matches the sales information reported to the city.

Agency Response: Agree, Implementation Date – Aug. 31, 2020

The Treasury Division's Tax Technician Specialist Could Improve Identification of Abnormal Payment Trends and Increase Frequency of Communication

As introduced in the background, the Treasury Division has dedicated one of its full-time tax specialist positions to perform tasks related to the marijuana industry. We received a set of procedures outlining the review process to identify marijuana businesses with a risk of underreporting. According to these procedures, the specialist should review taxpayer payments and forward “abnormal” or “erratic” trends to the audit unit every six months. The businesses identified as a result of this process are then taken into consideration when selecting which marijuana businesses to audit.

We found that the frequency with which the marijuana tax specialist communicated abnormal and erratic payments to the audit unit were not occurring at regular six-month intervals — as required by Treasury Division’s procedures. Rather, there have been only two communications since this policy was put in place in 2018, one in September 2018 and the second in August 2019. Further, the procedure does not define what an “abnormal” or “erratic” payment trend is. This lack of detail precludes the specialist from knowing what to look for and what trends indicate a risk of underreporting.

U.S. Government Accountability Office standards say management should create procedures with enough detail to allow management to ensure the staff carry out the assigned tasks. Additionally, audit standards developed by the American Institute of Certified Public Accountants say when analyzing financial data the specialist should define what results or trends should be

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expected. This allows the specialist to identify any deviations which may warrant further testing work.

In the case of Treasury’s tax specialist, these standards would require the procedures to clearly define what an “abnormal” or “erratic” payment trend is. Clearly defining what an abnormal tax payment trend is would help ensure the specialist identifies all businesses that possess a risk of underreporting tax information. During the period from August 2018 through September 2019, the tax specialist identified the following “abnormal” payment trends that were not based on clearly defined expectations for the analysis:

- Multiple instances when more sales were reported to the city than to the state; and
- One instance of a business reporting the same amount of retail sales for four months in a row.

Because Treasury’s procedures do not lay out what the expected pattern is for tax payments, we developed our own set of expectations based on how we interpreted “abnormal” payment trends, which consist of the following:

- Tax payment changes for a two-year period are expected to not vary by more than 100% of the average payment change calculated for all recreational marijuana businesses;
- There should not be matching tax payments from the same business between months; and
- Businesses should report the same amount of sales to both the city and the state for each month.

Using these expectations, we performed our own analysis with the same dataset used by the marijuana specialist, and we identified additional payments that do not conform to our expectations. These included:

- Several instances of large fluctuations in monthly sales reported by marijuana businesses;
- Several instances — in addition to the one the specialist identified — of marijuana businesses reporting the exact same amount of retail sales for several consecutive months; and
- Several instances of marijuana businesses reporting higher retail sales to the state than the city.

Failing to identify all abnormal or erratic payment trends means the marijuana businesses that potentially pose a high risk of noncompliance are not being brought to the attention of the audit unit. Furthermore, the risks identified are not being conveyed to the audit unit in a timely manner. Both of these factors reduce the audit unit’s effectiveness in ensuring all taxes owed to the city are being properly reported and collected.
The cause of these issues is that the procedures are not well defined and do not describe abnormal payment trends sufficiently for staff to comply. When discussing this with Treasury’s management, they explained the procedures are informal and do not necessarily need to be followed.

**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 Response: Agree, Implementation Date – Aug. 31, 2020**

The audit unit developed tax audit procedures specific to the marijuana industry because of the unique risk posed by the industry, which stems from the fact marijuana businesses often produce the products they will ultimately sell. This is opposed to other types of industries in which retailers purchase the products they will ultimately sell from an outside supplier. Purchasing from a supplier creates a transaction trail making it harder to understate sales. To address the heightened risk of not always having a documentation trail, the audit unit requires additional sources of information from the state’s seed-to-sale inventory tracking system, Metrc.

MORE INFORMATION
Find a list of tax-funded services on page 7.
Similar to a regular tax audit, the procedures require auditors to reconcile a business’s sales information to the tax returns it submitted to the city. In contrast to a regular tax audit, reconciliation procedures also require auditors to match the business’s sales information to information held in Metrc.

According to the audit unit, common errors the unit has identified during marijuana audits include missing or incomplete data that supports wholesale transfers and inaccurate sales tax information that supports a reconciliation between a sales tax return and a business’s retail sales records. Wholesale transfers are when marijuana products are transferred from one retailer to another without any sales tax applied. Sales tax is not applied to wholesale transfers because they are not sales made directly to customers. Metrc’s monthly sales report and the wholesale transfers report can provide additional evidence to ensure a business’s sales information reported to the city is complete and accurate.

In addition to the requirements laid out by the audit unit’s marijuana tax audit procedures, leading audit standard-setting bodies such as the American Institute of Certified Public Accountants, the U.S. Government Accountability Office, and The Institute of Internal Auditors all require findings be supported with relevant information.

Professional auditing standards provide a framework for performing high-quality audit work that addresses areas such as the extent of evidence required to support audit conclusions and documentation of supervision of audit work. In the case of a sales tax audit, this means the audit assessment — whether $0 or $100,000 — should be supported with enough information to ensure the assessment is accurate.

This standard of evidence would suggest the audit unit should not rely on one source of evidence, but rather, it suggests the unit should use both internal sales records and Metrc information when performing a marijuana sales tax audit. Table 1 on the following page lists the types of Metrc reports available to auditors and explains why each is important to verify businesses’ sales tax information.

While the audit unit’s procedures specifically require auditors to use the Monthly Sales Report and the Wholesale Transfers Report, the procedures do not require auditors to pull a Waste Report. However, according to staff at the state’s Marijuana Enforcement Division, the Waste Report can be used to see whether large amounts of waste are being reported — which may trigger further investigation to determine whether the amount was disposed of properly or whether there was a risk it was sold outside the sales system.

The state provided us with the average number of times waste was reported from the city’s marijuana businesses and the average amount reported.

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22 Three sources of audit standards contain similar language for obtaining relevant information to support audit findings. These include: The American Institute of Certified Public Accountants’ standards, Government Auditing Standards, and International Standards for the Professional Practice of Internal Auditing.
On average, there were 9 pounds of marijuana product removed from each recreational marijuana store’s inventory during the period from July 2017 through June 2018. If a store incorrectly removed product from the store or if there was not a valid reason to dispose of the product, then there is a risk the business reduced the amount of taxable product from its tax information submitted to the city.

### TABLE 1. Using Metrc Reports to Verify Accuracy and Completeness of Sales Information

<table>
<thead>
<tr>
<th>Metrc Report</th>
<th>Information in Report</th>
<th>Use During an Audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monthly Sales Report</td>
<td>Transaction-level sales for each month</td>
<td>Allows auditors to use a second source to verify whether a business’s sales information matches the taxable sales listed on its tax returns</td>
</tr>
<tr>
<td>Wholesale Transfers Report</td>
<td>The number of transfers, amount of product transferred, and the identification of the receiver and sender</td>
<td>Transfers can be deducted from a marijuana business's taxable sales. This report can be used to verify the number and amount of deductions made to ensure all taxable sales were included correctly.</td>
</tr>
<tr>
<td>Waste Report</td>
<td>The amount of product removed from the store’s inventory because of various factors, such as product recalls or expired product</td>
<td>Provides a check on the reasonableness of a product not sold. If a large amount of waste is identified, auditors can ensure whether there was a valid reason to remove the product from the business’s inventory.</td>
</tr>
</tbody>
</table>

**Source:** Auditor’s Office analysis of information compiled from Treasury’s audit unit and the Colorado Marijuana Enforcement Division.

**FIGURE 7. Waste Data Reported in the Metrc System by Marijuana Businesses in Denver**

![Medical marijuana stores](MedicalMarijuanaStores.png)

**Medical marijuana stores**

- **188 licenses**
- **July 2017‒June 2018:** 2.7 pounds
- **July 2018‒June 2019:** 1.8 pounds

![Recreational marijuana stores](RecreationalMarijuanaStores.png)

**Recreational marijuana stores**

- **182 licenses**
- **July 2017‒June 2018:** 9 pounds
- **July 2018‒June 2019:** 8 pounds

**Source:** Graphic designed by Auditor’s Office staff using information from the Colorado Department of Revenue’s Marijuana Enforcement Division.

During July 2017 through June 2019, Figure 7 above shows these averages for both recreational and medical marijuana stores.
We reviewed every marijuana sales tax audit completed from July 2018 through June 2019 to see what information was used by Treasury to identify underreported or unpaid sales taxes. We found issues with each of the 23 sales audits completed during this period. Figure 8 provides a summary of the issues identified. Specifically, it lists the type of report and the number of tax audits in which we did not find evidence of its use during the tax audit. Only five of the 23 tax audits used any of the three reports from Metrc.

Without using information from these reports, the audit unit may have not identified all taxable sales that should have been reported and paid to the city.

### The Treasury Division’s Audit Unit Does Not Retain Pertinent Audit Documentation that Demonstrates Supporting Workpapers and Supervisory Review

During our examination of the 23 tax audit files discussed above, we also looked at the audit unit’s review process used to ensure audit assessment calculations are accurate.

We found the audit unit’s review process does not follow leading audit standards or the city’s records retention policy. Figure 9 on the following page describes the specific issues we found.

According to leading audit standard-setting bodies, supervisors should perform a review of audit evidence, and this review should be documented and retained. Additionally, the city’s records retention policy requires the audit unit to maintain tax audit information for six years after an audit’s completion. However, this policy does not explicitly state Treasury’s audit

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24 City and County of Denver, General Records Retention Schedule § 30.190 (November 2019).
unit should retain all supporting documentation used to arrive at the tax assessment for each audit. We compared the city’s records retention practice to the IRS and the state of Colorado.25 Both of these entities require the supporting documentation that is directly relevant to findings and conclusions in an audit to be retained along with the audit file for a period of at least 10 years. All information critical to the audit or that supports a tax adjustment should be included in the audit file as evidence to the findings.

Our work showed Treasury does not retain documentation in its audit files that supports the amount of tax assessment — specifically, the amount of sales Treasury is using to calculate its assessment. In Treasury’s tax audit files that we reviewed, 19 out of 23 files did not include supporting documentation for the amount of sales. This information is used to determine whether a business underreported sales or underpaid city taxes. This does not conform with leading audit practices. For example, the IRS requires that when a tax adjustment is made, all critical information supporting the amount of that adjustment is retained in the audit file.26

Our team also looked at tax audit practices in other states including Indiana, Michigan, New Jersey, and Arizona.27 All of these states require auditors to support amounts used in tax audit calculations with copies of the documents used to arrive at those amounts in the audit workpapers.


When auditors do not indicate what information was used to perform the audit or retain the support documentation, supervisors are unable to perform a complete verification of the work and accuracy of the audit assessment. As a result, the audit assessment may be over- or understated. Although each audit file has a cover sheet indicating supervisors have signed off on the entire file, the individual workpapers used to calculate the audit assessment lacked an indication of review at a more detailed level.

Specifically, in each audit file we looked at, the individual reconciliation workpapers contained a spot for the supervisor to initial, indicating their review. Without this detailed review at the workpaper level, there is a risk the supervisor did not review the calculations used to inform the audit assessment or they simply performed a cursory review. If supervisors do not catch inaccurate audit assessment calculations, the city may not collect all the revenue it is owed.

There are several reasons behind the issues we found:

1. The audit unit does not follow a set of audit standards to inform how audits are conducted and reviewed;
2. The audit unit lacks controls to ensure its own marijuana tax audit procedures are consistently followed; and
3. The audit unit does not retain supporting documentation according to best practices. Audit unit staff explained they do not retain supporting documentation beyond six months of the completion of an audit in order to protect personal taxpayer information.

As a result, an experienced auditor who conducts a peer review or an inspection at a later point 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.

**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 Response: Agree, Implementation Date – Aug. 31, 2020**
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 Response: Disagree

Auditor’s Addendum: See page 38 under Recommendation 1.6

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 Response: Agree, Implementation Date – Aug. 31, 2020

The Treasury Division Is Not Adequately Measuring and Monitoring the Efficiency of Its Audit Unit

According to the Organisation for Economic Co-operation and Development, an audit unit plays a critical role in the work of tax administration bodies because of its role in ensuring taxpayer compliance, generating revenue to fund taxpayer services, and the level of staff resources used. Therefore, OECD suggests an audit unit’s operations should be supported by suitable management practices including the development and implementation of a comprehensive set of performance measures that are carefully tracked.

This leading practice applies to Treasury’s audit unit as it has a direct relationship to the achievement of the Tax Compliance Section’s two overarching goals of making sure taxpayers report and pay all taxes owed to the city. Additionally, the audit unit represents half of the total staff resources within Treasury’s Tax Compliance Section.


29 Ibid.
“Efficiency” is defined as the extent to which the quantity of resource use is minimized and is typically measured with ratios of input to output. While measuring efficiency is important to all entities — both private and public sector — it has a much greater focus in the public sector. This greater focus is because taxpayers want to know how well public officials and managers are meeting their responsibility for achieving operating performance results with taxpayers’ money.

We found the audit unit has not developed and implemented a comprehensive set of performance measures that address each of its goals and objectives as laid out in the unit’s 2019 strategic plan, referred to as the Audit Plan. Currently, the unit measures the following items:

1. Number of audits completed in a year;
2. Amount of revenue recovered through audit assessments in a year;
3. Length of time to complete audits;
4. Hours each auditor spends on tax audits per year;
5. Number of audits that require auditors to be out in the field at a taxpayer’s location versus the number of audits that can be completed through correspondence (i.e., a desk audit); and
6. Number of audits that used a statistical sampling method when selecting transactions to audit versus the number of audits that used a nonstatistical sampling selection method.

Not only is the audit unit’s list of performance measures short in not addressing all its stated objectives, but furthermore, two of the six measures listed above — specifically numbers five and six — do not even provide an assessment of the unit’s performance. Moreover, the unit does not compare results of the six performance measurements it adheres to with any of the following:

1. Expected resource use or efficiency level;
2. Past performance (trending); or

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3. Efficiency rate of other units doing the same activity, such as sales tax audits performed by the audit unit in industries other than the marijuana industry.

Leading practices include the development and use of a comprehensive set of performance measures and close monitoring of the results and quality of operations achieved in practice.\textsuperscript{32}

According to the city’s Peak Academy, a program designed to train city employees to improve the effectiveness and efficiency of city operations, there is no one perfect set of performance metrics; the right metrics depend on the agency’s goals and objectives and may require multiple iterations to discover more about the process in question.\textsuperscript{33} The Peak Academy suggests focusing on a mix of metrics that measure different aspects of the service being provided, such as efforts and accomplishments.

Once management has created its comprehensive set of performance metrics, the next step is determining whether efficiency is satisfactory. Determining whether efficiency is satisfactory is done by comparing performance metrics with some criteria. Three common criteria used to assess the adequacy of efficiency are those enumerated above: expected results, trending of past performance, and benchmark of other units performing the same thing.\textsuperscript{34}

Comparing performance with expected resource use and prior years provides critical knowledge on whether performance is in line with management’s expectations and whether efficiency has increased or declined. However, without taking the third and final step of comparing efficiency rates to other units performing the same type of work, management would be unable to determine whether the current level of performance is satisfactory. For example, to understand whether efficiency metrics of marijuana audits are good or bad, management could possibly compare these metrics with those of nonmarijuana audits.

The effect of not adequately measuring efficiency leads to a lack of accountability. Without adequate measurement, management cannot determine whether the resources they have been entrusted with were efficiently used to achieve the purposes for which the resources were furnished. Further, management is unable to identify areas of potential productivity improvement or areas of potential cost reduction, to serve as a scorekeeping device of management’s achievement in improving efficiency. Without this scorecard, it is difficult for management to ensure they are contributing in an optimal way to the Tax Compliance Section’s two


\textsuperscript{33} “Denver Peak Academy Workbook,” City and County of Denver, Mayor’s Office, accessed Dec. 31, 2019, https://www.denvergov.org/content/dam/denvergov/Portals/728/documents/Peak_Performance/Peak_Academy/Peak%20Workbook.pdf.

overarching goals of making sure taxpayers report and pay all taxes owed to the city.

Management’s inability to contribute in an optimal way is evidenced by the random and erratic results we observed when trending our own set of efficiency ratios, which we created to assess the audit unit’s efficiency when performing marijuana audits.

Our metrics measured yield, productivity, time consumption, and quantity. We calculated annual ratios for each year within the five-year trend period of July 2014 through June 2019. We achieved similar results across most of our ratios. Results were up and down and showed no clear direction the audit unit’s efficiency was getting better, worse, or staying the same. Using the same set of efficiency metrics used to assess marijuana audits, we calculated metrics for nonmarijuana audits to use as a benchmark comparison of other units doing the same activity. Again, the results do not clearly indicate that the level of efficiency of marijuana audits is better, worse, or the same as nonmarijuana audits.

We determined a lack of management control has led to the audit unit not adequately measuring and monitoring efficiency. Management control is defined as setting goals and objectives, developing appropriate measures, calculating those measures, assessing the significance and reasons for a variance, and taking action as warranted.35 While the Treasury Division’s management has established goals and objectives, the four remaining pieces — of developing measures, performing the measures, assessing variance, and responding — are not being addressed.

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35 Ibid., 69.
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); and
- 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 Response: Agree, Implementation Date – Aug. 31, 2020

The Treasury Division Is Not Adequately Identifying Unlicensed Marijuana Delivery Businesses Operating in Denver

As required by city ordinance, marijuana businesses operating in Denver are required to:

- Have a medical or recreational marijuana license with the city;\(^ {36} \)
- Collect marijuana sales taxes from customers;\(^ {37} \)
- Report marijuana sales taxes to the city via tax returns;\(^ {38} \) and
- Remit marijuana sales taxes to the city.\(^ {39} \)

On top of city ordinance, state regulations also say no person shall sell marijuana unless they have a state marijuana license, and any sale of retail marijuana must occur within the retail marijuana store’s restricted access area (i.e., no deliveries).\(^ {40} \)

We performed limited testing consisting of an online search to identify marijuana delivery businesses operating without a license and disregarding city sales tax laws. After a simple Google search, we were able to identify three unlicensed marijuana delivery businesses operating in Denver and not reporting or paying sales taxes.

\(^ {36} \) Denver Revised Municipal Code § 6-206 and § 24-503.
\(^ {40} \) 1 Colo. Code Regs. 212-3 § 1-105 and § 6-110.
These unlicensed marijuana delivery businesses had websites with pricing, products, and contact information for marijuana sales deliveries. Between the three businesses, there were 169 online customer reviews dating back over three years.

When we brought these businesses to Treasury’s attention, they were unaware of the activities. Treasury’s opinion was that the delivery businesses were nothing more than a scam designed to steal from unknowing customers. While we could not confirm whether these are scams, it does seem likely the three businesses are, in fact, making marijuana sales and are not scams.

First, one of the three delivery businesses requires cash payments upon delivery with the exchange taking place in a face-to-face meeting. Such an exchange makes it difficult for a scam delivery business to rip-off a purchaser. Second, a significant amount of the 169 Google reviews posted on the three businesses’ web sites were from satisfied customers — which also indicates actual sales are, in fact, being made. Third, we contacted the businesses and confirmed they are making Denver deliveries.

The previously discussed tax specialist is also responsible for searches to identify marijuana businesses operating illegally. Illegal operations include not possessing the proper licensure and not reporting or remitting sales tax to the city. We found Treasury has not developed adequate search methods for the marijuana specialist to uncover unlicensed marijuana delivery businesses not reporting and paying sales tax.

In 2019, the state legislature legalized the delivery of marijuana in Colorado. Local jurisdictions will have the right to allow or ban marijuana deliveries to customers within their borders. The state will begin accepting licensing applications for the delivery of medical marijuana in 2020 and for the delivery of recreational marijuana in 2021.

What this means for Denver is that the risk of more and more online marijuana delivery businesses operating without a license and disregarding city sales tax laws is most likely going to increase. Marijuana delivery businesses pose a high risk of revenue loss to the city because the businesses are inherently harder to trace because of their mobile nature. Once marijuana delivery businesses begin legally operating, it will be critical to have internal controls already in place to detect unlicensed marijuana delivery operations in a timely manner.

With the imminent legalization of delivery businesses, Treasury should ensure these businesses report and remit sales taxes to avoid loss of tax revenue to the city. A potential loss in tax revenue is compounded by the fact that being unlicensed also means the city loses out on license fees. The following breaks down the licensing revenue the city receives related to the marijuana industry, as of January 2020:

- New city recreational marijuana license issued: $5,000
• New city medical marijuana license issued: $5,000
• Yearly city recreational marijuana license renewal: $5,000
• Yearly city medical marijuana license renewal: $3,000
• City share of recreational marijuana license issued by state of Colorado for city marijuana businesses: $2,500

If Treasury's methods for identifying unlicensed marijuana delivery businesses are not improved, it could lead to potentially an even bigger loss of tax revenue and licensing fees in the future.

**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; and
- Identifying potential unlicensed businesses through the city's business license complaint system and the Denver 311 program.

**Agency Response: Agree, Implementation Date – Aug. 31, 2020**

We found the Treasury Division is not communicating with the Department of Excise and Licenses to obtain state marijuana licensing information. This data would allow Treasury to better perform the division's monthly process to ensure all marijuana businesses operating in the city are properly licensed.

To complete this monthly process, Treasury's marijuana industry tax specialist performs two reconciliations. The first reconciliation involves matching the marijuana license data from the city's licensing database, Accela, with data in the city's GenTax system. The second reconciliation involves matching city licensing data with the state of Colorado Marijuana Enforcement Division's publicly available license database.

For the GenTax reconciliation, the marijuana tax specialist takes license information from Accela regarding the type of license and whether a license is active and compares the Accela information to the license information in GenTax. This comparison is done for each individual marijuana licensee. The purpose is to ensure every marijuana business has a tax account and that
every marijuana business with a tax account has a license.

The reconciliation with state records involves the marijuana tax specialist taking license information from the city’s Accela system and matching that with what is contained in the Marijuana Enforcement Division’s state license database. The purpose of the state reconciliation is to ensure all marijuana businesses operating in Denver have a valid state license.

These reconciliations are manual and time-intensive, leading to an inefficient use of Treasury’s only tax specialist dedicated primarily to the marijuana industry. This reconciliation process detracts from the time that could be better spent supporting Treasury’s goals of ensuring all taxes owed to the city are properly reported and collected.

We contacted Excise and Licenses and found that it receives state marijuana licensing information directly from the state. Further, we were informed Excise and Licenses has a monthly report in its Accela licensing system that provides updates on city marijuana licensing information such as suspensions, revocations, and pending applications.

According to U.S. Government Accountability Office standards, management should obtain relevant data from reliable internal and external sources in a timely manner based on the identified information requirements.41

We inquired with Treasury’s marijuana tax specialist and learned they were unaware Excise and Licenses receives marijuana licensing information directly from the state and that they could avoid duplication of effort by acquiring state data through the city’s Department of Excise and Licenses.

**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 Response: Agree, Implementation Date – Aug. 31, 2020**

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Colorado law requires a portion of the money collected from the state's recreational marijuana sales tax be distributed back to the local municipalities where it was sold. This rebate, referred to as a state “shareback” payment, is calculated as 10% of total recreational marijuana tax revenue collected.

Shareback payments are only applicable to recreational marijuana sales and do not apply to medical marijuana sales. The amounts distributed back to each municipality are proportional, based on collections of recreational marijuana sales tax revenue earned from a particular jurisdiction. For example, if the City and County of Denver accounted for 31% of total recreational marijuana sales tax collections in the state, it would then receive 31% of the total shareback payment. Figure 10 depicts this hypothetical example of the state shareback.

Shareback payments are paid monthly to local jurisdictions. Each month when the city receives its state shareback payment, the amount is credited to the city's Treasury, but no one working for the city checks the accuracy of the payment to make sure it is correct based on Denver's recreational marijuana sales. The problem with not verifying the accuracy of monthly shareback payments is that the state could have overpaid or underpaid.

Underpaying means lost tax revenue to the city, which in turn equates to less money to fund services for Denver residents. Overpayment, meanwhile, means the city owes the state money.

According to state law, local jurisdictions receiving state shareback payments are permitted to request and obtain supporting documentation from the state to verify the accuracy of the payments. Further, each month the Colorado Department of Revenue already provides the city's Treasury...
Division with data that could be used to ensure the shareback payment is accurate.

We reviewed 66 months (five and a half years) of shareback payments. The period tested dates to the first shareback payment introduced in 2014 with the legalization of recreational marijuana and ends June 2019.

Of the 66 months tested, we identified variances in 18, or 27%, of the months — all of which occurred in the most recent two years (June 2017–June 2019). Specifically, seven of the 12 months in 2017, nine of the 12 months in 2018, and two of the six months in 2019 had differences. These differences ranged as high as $6,334 in an overpayment from the state. We inquired with the Colorado Department of Revenue and the city’s Treasury Division to see whether either could explain the variances, but neither could.

Our work determined Treasury lacks proper safeguards to ensure shareback payments are accurate. While these discrepancies were small in amount, they went unnoticed, meaning that future discrepancies also will go unnoticed and possibly be more substantial in amount.

Based on discussions with Treasury and the Controller’s Office, the safeguards have not been put in place because of confusion over which city agency should be responsible for checking the accuracy of the shareback payments. Both Treasury and the Controller’s Office referred us to the other at the time we finalized our testing in December 2019.

According to U.S. Government Accountability Office standards, management should evaluate both internal and external sources of data for reliability.\textsuperscript{44} Not comparing external sales data provided by the state with internal sales data from Treasury means the city is accepting monthly shareback payments without verification. Further, the city’s Fiscal Accountability Rules require every transaction recorded by the city to include adequate supporting documentation that provides a clear picture of the transaction and shows the supporting documentation equals the amount of the transaction.\textsuperscript{45}

Performing this validation would not consume a significant amount of time, as we reviewed all 66 months of the state shareback payment. Each month took no more than 15 minutes.


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; and
- Comparing the state’s shareback payment received to the amount reported by the state as being owed.

Agency Response: Agree, Implementation Date – April 30, 2020
RECOMMENDATIONS

The agency narratives below are reprinted verbatim from the agency’s response letter, shown in the next section of this report.

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; and
- 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 Response: Agree, Implementation Date – Aug. 31, 2020

Agency Narrative: The Treasury Division strives to use the most accurate and informative data possible in making audit selections. We have several options that we are looking into to improve our data analytics and continue to look for ways to improve this selection process in any way possible.

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 Response: Agree, Implementation Date – Aug. 31, 2020

Agency Narrative: The Treasury Division has corrected the problem noted during the audit and will develop a validation process to avoid any future problems.

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; and
• Verify sales information reported to the state matches the sales information reported to the city.

**Agency Response: Agree, Implementation Date – Aug. 31, 2020**

**Agency Narrative:** The Treasury Division will ask the State of Colorado for information regarding audits of Marijuana businesses with locations in Denver and incorporate this information to our selection process. Further, the Treasury Division will seek Marijuana sales data from the State of Colorado and match it to our records.

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 Response: Agree, Implementation Date – Aug. 31, 2020**

**Agency Narrative:** The Treasury Division will adopt standards and create procedures identify, detect and report erratic or abnormal payment trends and report them to the Audit Manager for follow up as deemed necessary.

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 Response: Agree, Implementation Date – Aug. 31, 2020**

**Agency Narrative:** The Treasury Division will expand our current standards for conducting tax audits of marijuana businesses.

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 Response: Disagree

Agency Narrative: 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.

Auditor’s Addendum: 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.

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 Response: Agree, Implementation Date – Aug. 31, 2020

Agency Narrative: The Treasury Division agrees with this recommendation and we will develop safeguards to ensure marijuana tax audit procedures are consistently followed.

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); and
- 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 Response: Agree, Implementation Date – Aug. 31, 2020**

*Agency Narrative: The Treasury Division agrees with this recommendation for marijuana tax audits and will develop performance measures to address the goals and objectives for the audit unit.*

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; and
- Identifying potential unlicensed businesses through the city's business license complaint system and the Denver 311 program.

**Agency Response: Agree, Implementation Date – Aug. 31, 2020**

*Agency Narrative: The Treasury Division agrees with this recommendation. We are unaware of any legally operating unlicensed marijuana businesses in Denver. However, we agree that using a variety of tools to identify any unlicensed marijuana businesses is appropriate.*

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 Response: Agree, Implementation Date – Aug. 31, 2020**

*Agency Narrative: The Treasury Division agrees to seek reports that could make our reconciliation process more efficient. We will consult with Excise and Licenses to review the information they have available.*
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; and
- Comparing the state's shareback payment received to the amount reported by the state as being owed.

**Agency Response: Agree, Implementation Date – April 30, 2020**

*Agency Narrative: We agree, the Treasury Division's Tax Compliance section and the Controller's Office implemented these processes at the beginning of 2020.*
April 6, 2020

Auditor Timothy M. O’Brien, CPA  
Office of the Auditor  
City and County of Denver  
201 West Colfax Avenue, Dept. 705  
Denver, Colorado 80202

Dear Mr. O’Brien,

The Office of the Auditor has conducted a performance audit of Marijuana Taxation. This memorandum provides a written response for each reportable condition noted in the Auditor’s Report final draft that was sent to us on April 2, 2020. This response complies with Section 20-276 (c) of the Denver Revised Municipal Code (D.R.M.C.).

AUDIT 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; and
- Analyzing tax audit results regularly to determine how effective the risk indicators used to select audits were and to determine whether changes are needed.

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Narrative for Recommendation 1.1
The Treasury Division strives to use the most accurate and informative data possible in making audit selections. We have several options that we are looking into to improve our data analytics and continue to look for ways to improve this selection process in any way possible.

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.

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Narrative for Recommendation 1.2
The Treasury Division has corrected the problem noted during the audit and will develop a validation process to avoid any future problems.

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; and
- Verify sales information reported to the state matches the sales information reported to the city.

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Narrative for Recommendation 1.3
The Treasury Division will ask the State of Colorado for information regarding audits of Marijuana businesses with locations in Denver and incorporate this information to our selection process. Further, the Treasury Division will seek Marijuana sales data from the State of Colorado and match it to our records.

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.

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Narrative for Recommendation 1.4
The Treasury Division will adopt standards and create procedures identify, detect and report erratic or abnormal payment trends and report them to the Audit Manager for follow up as deemed necessary.

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.

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Narrative for Recommendation 1.5
The Treasury Division will expand our current standards for conducting tax audits of marijuana businesses.

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.

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Narrative for Recommendation 1.6
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.
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.

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Narrative for Recommendation 1.7
The Treasury Division agrees with this recommendation and we will develop safeguards to ensure marijuana tax audit procedures are consistently followed.

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); and
- Performance measurement rates of other units doing similar work.

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

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Narrative for Recommendation 1.8
The Treasury Division agrees with this recommendation for marijuana tax audits and will develop performance measures to address the goals and objectives for the audit unit.
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; and
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Narrative for Recommendation 1.9
The Treasury Division agrees with this recommendation. We are unaware of any legally operating unlicensed marijuana businesses in Denver. However, we agree that using a variety of tools to identify any unlicensed marijuana businesses is appropriate.

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.

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Narrative for Recommendation 1.10
The Treasury Division agrees to seek reports that could make our reconciliation process more efficient. We will consult with Excise and Licenses to review the information they have available.

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;
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<tr>
<td>Agree</td>
<td>4/30/20</td>
<td>Chris Tubbs (720) 913-5206</td>
</tr>
</tbody>
</table>

Narrative for Recommendation 1.11
We agree, the Treasury Division’s Tax Compliance section and the Controller’s Office implemented these processes at the beginning of 2020.

Please contact Don Korte at 720-913-9339 with any questions.

Sincerely,

Steven L. Ellington
Treasurer

cc: Valerie Walling, CPA, Deputy Auditor
Katja E. V. Freeman, MA, MELP, Audit Director
Patrick Schafer, MBA, CPA, CIA, CFE, Audit Supervisor
OBJECTIVE

The objective of our audit was 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.

SCOPE

The audit assessed the effectiveness and efficiency of the Treasury's Division's audit unit with regard to the administration, enforcement, and collection of taxes from recreational and medical marijuana businesses. Although our primary focus was marijuana businesses operating in the City and County of Denver, in some cases it was necessary to extend our audit procedures to evaluate nonmarijuana businesses within the city.

The audit period covered a time frame from July 1, 2017, through June 30, 2019. However, certain audit procedures, such as those related to state shareback payments, data validation within the GenTax system, analysis of the audit unit’s audit selection process, and our trending of the audit unit’s efficiency ratios stretched outside the July 2017–June 2019 date range.

METHODOLOGY

We applied various methodologies to gather and evaluate information related to our audit objectives. These included but were not limited to:

- Reviewing:
  - The Denver Charter
  - City Fiscal Accountability Rules
  - City ordinances
  - State regulations
  - State laws
  - The Treasury Division's internal policies and procedures

- Interviewing:
  - Colorado Department of Revenue personnel
  - Controller's Office staff
  - Department of Excise and Licenses personnel
  - Treasury staff (management, supervisors, tax auditors, and the tax technician specialist)
• Analyzing:
  ○ Retail marijuana sales data from the state and from the city's GenTax system to identify abnormal payment trends in both sets of data
  ○ Data in the city's GenTax system to evaluate data reliability
  ○ The average tax audit assessments between marijuana businesses and nonmarijuana businesses
  ○ Whether the Treasury Division's audit unit risk indicators help predict tax audit assessment for marijuana businesses
  ○ Retail marijuana sales for Denver from the state of Colorado's retail marijuana reports and comparing that to sales recorded by the city in GenTax for retail marijuana to identify discrepancies
  ○ The amount of shareback revenue received by the city and comparing it to the state's tax report for accuracy
  ○ Through internet searches, unlicensed marijuana businesses operating within the City and County of Denver. For any potential unlicensed marijuana businesses identified, a search was performed in GenTax, the city's business licensing software (Accela), and the state's Marijuana Enforcement Division's website to determine whether the business had a valid marijuana license with the city and the state.
  ○ Recalculated state shareback payments from the state of Colorado
  ○ Aggregated state tax audit data received from the Colorado Department of Revenue for state tax audits performed within the City and County of Denver from July 2017 through June 2019
  ○ The audit unit's tax audit files of marijuana businesses to gain an understanding of the data being used as well as how city sales tax audits were being performed
  ○ Performance metrics for the audit unit, including calculating and trending efficiency ratios of the audit unit's performance for the period of 2015 through 2019
  ○ Through benchmarking, our calculated audit unit efficiency ratios against the Colorado Department of Revenue's Taxation Division efficiency ratios
APPENDICES

Appendix A – Audit Selection Analysis Methodology

This appendix details the methodology used to analyze the audit unit's assumptions regarding the risks associated with the marijuana industry. We conducted our inferential and predictive statistical analysis using the statistical software program STATA.

T-Test Methods

To analyze the audit assessment values between marijuana businesses and nonmarijuana businesses, we used an inferential statistical test called a “t-test.” The results of the t-test allowed us to determine whether the averages between the two groups’ audit assessments are statistically different. To complete this test, we used the audit assessment amount of 894 audits conducted by Treasury's audit unit from the period of January 2018 through August 2019. The listing of audits, dates, and related assessment amounts were provided to us by the audit unit in an “Audit History Report” retrieved from Treasury's GenTax system. The “Audit History Report” included data fields that indicated whether or not the business was a marijuana business. This indicator was used to create two groups: 1) audit assessments of marijuana businesses and 2) audit assessments of nonmarijuana businesses.

Because a t-test requires normally distributed data, we evaluated the audit assessment values for normalcy and found they do not follow a normal distribution. Rather, the values are skewed; there are many small values and a few very large values. To adjust these values to a normal distribution, we calculated the natural log of each audit assessment value — a common technique to normalize data. We visually inspected the new distribution and confirmed the adjusted values fit a normal distribution. The graph in the top half of Figure 11 on the following page depicts the distribution of the audit assessment before we made any adjustment, while the bottom half of Figure 11 shows the distribution after the log transformation.

Next, we used the adjusted values in the t-test. Note: By using log-normal values instead of the unadjusted dollar amounts, the t-test excluded any zero-dollar audit assessments or any negative dollar audit assessments. In total, 67 audit assessments were removed — all of which were audits conducted of nonmarijuana businesses. In total, we compared the average audit assessments between 52 of the marijuana businesses and 775 nonmarijuana business using the t-test. The results of the t-test with the remaining audit assessments show a p-value of 0.24, which is greater than the statistically significant cut-off level we used of 0.05 — indicating there is no statistical difference between the average value of audit assessments of the two groups.

Regression Methods

To analyze the risk indicators of prior audit history and a business's total remittance paid to the city, we ran several regression models to test the audit unit's assumptions that these were effective risk indicators to detect underreporting. The regression models include variables constructed from two sources: the Treasury Division's “Top 10% Remitters Report” and an “Audit History Report” pulled from GenTax. The “Top 10% Remitters Report” covers the period of January 2018 through December 2018 and contains the top 10% business remitters in the city and which of those businesses are marijuana businesses. The "Audit History
From this, we created a dataset using only audits completed during the period of January 2018 through November 2019. We used a count formula in Excel to identify the number of times each of these businesses had been audited before the completion of the most recent audit — which fell within the period of January 2018 through November 2019. Lastly, we pulled the total remittances of businesses included in the “Top 10% Remitters Report,” and we identified which businesses in the new dataset were marijuana businesses.

We imported this dataset into STATA to analyze the effect total remittance and prior audit history had on the audit assessment for marijuana businesses during the period of January 2018 through November 2019. The analysis included 69 marijuana businesses, which is the total number of businesses audited during the period of analysis. Of the 69 businesses, 47 were included in the “Top 10% Remitters Report,” and seven had been audited once before the most recent audit.

The results of the regression analysis are displayed in Table 2 on the following page. We performed three types of regression analyses. In each analysis, the dependent variable was the audit assessments for marijuana businesses and the independent variables included a variable indicating whether the business was

![Figure 11: Distribution of Audit Assessment Amounts Before and After Log Transformation](image-url)
listed in the “Top 10% Remitters Report” and a variable indicating the number of times each business was audited before the most recent audit. We used a p-value of 0.05 to determine statistical significance of each predictor variable. For each regression analysis, we list the coefficients of each variable; coefficients show the effect an independent variable has on the dependent variable. However, the effect is only important if the variable has a statistically significant relationship to the dependent variable.

For the model results displayed in the Table 2 column titled “Linear Regression,” we created a histogram to examine the distribution of the audit assessments for the 69 businesses and found the distribution was skewed. Therefore, we took the natural log of each value to achieve a more normal distribution. By doing so, we decreased the number of observations in this analysis from the 69 to 64, because five audits resulted in a zero-dollar audit assessment that cannot be transformed into a natural log. We list the coefficients for each variable in Table 2. However, results show that neither the total remittance variable nor the prior audit history variable had a statistically significant relationship to audit assessment. Although the number of observations included in this analysis meets the acceptable threshold of 30 observations per independent variable, we performed additional analysis to help verify these results.

The column titled “Bootstrap Regression” in Table 2 contains the results of a technique referred to as “bootstrapping,” which is a method used to randomly pull observations from the dataset and perform the same analysis. This technique allowed us to learn whether the results of the linear regression were because of a small number of observations or if they would be reproduced using different random samples from the data. We performed 1,000 replications of the regression model and listed the coefficients for each variable in the “Bootstrap Regression” column. We received the same results: Neither the total remittance variable nor the prior audit history variable had a statistically significant relationship to audit assessment.

Lastly, the column titled “Poisson Regression” shows the results of a type of estimation technique that assumes the dependent variable is a count variable. In our case, it allowed us to include the observations of zero-dollar audit assessments. Therefore, this analysis included all 69 observations of audit assessments. Again, we list the coefficients in Table 2, but neither variable had a statistically significant relationship to audit assessment.

Exploratory Regression Analysis

We performed additional regression analysis to explore other risk indicators that may impact audit assessment. To do this, we identified a list of marijuana business characteristics, which is shown in Table 3 under the “Variable” column. Table 3 is shown across the following two pages.

We shared this list of variables with staff at the state of Colorado’s Taxation, Audit, and Compliance Division and received feedback that the list of variables we provided may help predict underreporting. After we
received feedback, we collected data for 69 marijuana businesses with an audit completed during the period of July 2014 through June 2019. Table 3 lists the description and data source for each of these variables.

Using the audit assessment for each business as the dependent variable, we ran several regression models. Overall, we found the following variables have a statistically significant relationship to audit assessment using a p-value cut-off of 0.05: recreational sales, total sales, businesses with both a medical license and a medical grow license, and dollar amount of issues related to occupational privilege taxes, or OPT. This means that each of these characteristics appears to be more effective at identifying the risk of underreporting than the other characteristics we analyzed. We list the specific effect of these variables in Table 3.

**TABLE 3. Description of Each Variable Used in the Exploratory Analysis**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
<th>Data Source</th>
<th>Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale Transfer Dollar Amount</td>
<td>The sum dollar amount of transfers made during the two-year period prior to the most recent audit</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Wholesale Transfer Count</td>
<td>The number of months a business included transfers on its tax return during the two years prior to the most recent audit</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Medical Sales</td>
<td>Includes the total of all nonrecreational marijuana sales such as medical sales, T-shirt sales, or paraphernalia sales for two years prior to the most recent audit</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Recreational Sales</td>
<td>Includes the total of all recreational marijuana sales for the two years prior to the most recent audit</td>
<td>GenTax</td>
<td>A $1 increase in recreational sales leads to a 0.42% lower audit assessment.</td>
</tr>
<tr>
<td>Total Sales</td>
<td>Includes the total recreational and medical sales for the two years prior to the most recent audit</td>
<td>Created by summing Medical Sales and Recreational Sales</td>
<td>A $1 increase in total sales leads to a 0.65% higher audit assessment.</td>
</tr>
<tr>
<td>License Type</td>
<td>Used to indicate what type of license was held by the business as of October 2019. Business license types included: medical sales, recreational sales, medical grow, recreational grow, medical manufacturer of infused products, and recreational manufacturer of infused products.</td>
<td>GenTax</td>
<td>A business with both medical grow and medical sales licenses has a 76% lower audit assessment compared to businesses without these licenses.</td>
</tr>
<tr>
<td>Number of Deductions</td>
<td>Includes the number of deduction types listed on a business’s tax return for each month within two years prior to the most recent audit.</td>
<td>GenTax</td>
<td>None</td>
</tr>
</tbody>
</table>

*Source:* Auditor’s Office analysis of risk indicators.

*Note:* We used a p-value of 0.05 to determine statistical significance. Table 3 continues on the next page.
**TABLE 3, CONTINUED.**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Definition</th>
<th>Data Source</th>
<th>Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>Count of OPT-Related Issues</td>
<td>Includes the number of months in which the business either had a delinquent payment or underpayment for the city's occupational privilege tax for the two-year period prior to the most recent audit.</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Dollar Amount of OPT-Related Issues</td>
<td>The sum dollar amount of the delinquent payments or underpayments on the city's occupational privilege tax during the two-year period prior to the most recent audit.</td>
<td>GenTax</td>
<td>A $1 increase in the sum dollar amount of OPT-related tax return issues leads to a 0.04% increase in audit assessment.</td>
</tr>
<tr>
<td>Count of Issues related to Sales and Use Tax</td>
<td>Includes the number of months in which the business either had a delinquent payment or underpayment for the city's sales and use tax for the two-year period prior to the most recent audit.</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Dollar Amount of Issues related to Sales and Use Tax</td>
<td>The sum dollar amount of the delinquent payments or underpayments on the city's sales and use tax during the two-year period prior to the most recent audit.</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Count of Zero-Dollar Returns</td>
<td>The number of months in which the business submitted either an occupational privilege tax return or a sales and use tax return with a $0 entry for the taxable amount</td>
<td>GenTax</td>
<td>None</td>
</tr>
<tr>
<td>Method of Return Filing</td>
<td>Includes the most frequent filing method for the business used during the two years prior to the most recent audit. The methods of filing include: paying through GenTax, paying in person, or paying with a check.</td>
<td>GenTax</td>
<td>None</td>
</tr>
</tbody>
</table>

**Source:** Auditor's Office analysis of risk indicators.

**Note:** We used a p-value of 0.05 to determine statistical significance.

Table 3 is continued from the previous page.
Appendix B – Efficiency Metric Trends

This appendix shows our creation and analysis of the audit unit’s activity covering the five-year period between July 1, 2014, through June 30, 2019. The metrics we used measure efficiency aspects covering the audit unit’s yield, productivity, time consumption, and quantity. We calculated annual ratios for each year within the five-year trend period for audits completed of marijuana businesses and nonmarijuana businesses.

Below we show a description of each ratio and show the results. As seen in figures 12-18, most of the results show a lack of a discernible trend. Results that increase one year then decrease the next do not allow us to determine whether the audit unit’s efficiency was getting better, worse, or staying the same.

**FIGURE 12.** Average Audit Assessment Revenue for Marijuana Audits and Nonmarijuana Audits

![Graph of Average Audit Assessment Revenue](source)

**Source:** Auditor’s Office analysis of information pulled from GenTax.

**FIGURE 13.** Average Audit Assessment Revenue Collected per Hour Spent on Marijuana Audits and Nonmarijuana Audits

![Graph of Average Audit Assessment Revenue per Hour](source)

**Source:** Auditor’s Office analysis of information pulled from GenTax.
FIGURE 14. Percent Change in Audit Assessment Revenue Collected from Marijuana Audits and Nonmarijuana Audits

Source: Auditor’s Office analysis of information pulled from GenTax.

FIGURE 15. Number of Marijuana and Nonmarijuana Audits Completed

Source: Auditor’s Office analysis of information pulled from GenTax.
**FIGURE 16.** Audit Assessment Revenue Collected per Time Available for All Employees for Marijuana Audits and Nonmarijuana Audits

![Graph showing revenue collected over time for marijuana and non-marijuana audits.](image)

*Source: Auditor's Office analysis of information pulled from GenTax.*

**FIGURE 17.** Turnover Rate of Marijuana and Nonmarijuana Audits

![Graph showing turnover rate for marijuana and non-marijuana audits.](image)

*Source: Auditor's Office analysis of information pulled from GenTax.*

**Note:** "Turnover rate" measures how quickly the audit unit completes its audits by comparing the number of audits completed during the year with the number of audits that were in progress at the beginning and end of that year.
FIGURE 18. Percentage of Marijuana and Nonmarijuana Audits Over Budget

<table>
<thead>
<tr>
<th>Period</th>
<th>Marijuana Audits</th>
<th>Nonmarijuana Audits</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 2014 to June 2015</td>
<td>31.2%</td>
<td>33.3%</td>
</tr>
<tr>
<td>July 2015 to June 2016</td>
<td>30.4%</td>
<td>24.1%</td>
</tr>
<tr>
<td>July 2016 to June 2017</td>
<td>30.0%</td>
<td>45.0%</td>
</tr>
<tr>
<td>July 2017 to June 2018</td>
<td>30.7%</td>
<td>25.0%</td>
</tr>
<tr>
<td>July 2018 to June 2019</td>
<td>35.4%</td>
<td>46.7%</td>
</tr>
</tbody>
</table>

Source: Auditor’s Office analysis of information pulled from GenTax.
Office of the Auditor

The Auditor of the City and County of Denver is independently elected by the citizens 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 citizen 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 of Denver. Our work is performed on behalf of everyone who cares about the City, including its residents, workers, and decision-makers.