

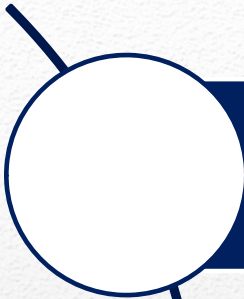


Audit of the City's Medical Marijuana Dispensaries

Office of the City Auditor

Jorge Oseguera, City Auditor

October 2017



Objective

- The objective of the Audit of the City's Medical Marijuana Dispensaries was to assess the controls surrounding the operations of the dispensaries and to identify areas of risk and opportunities for improvement.



Scope

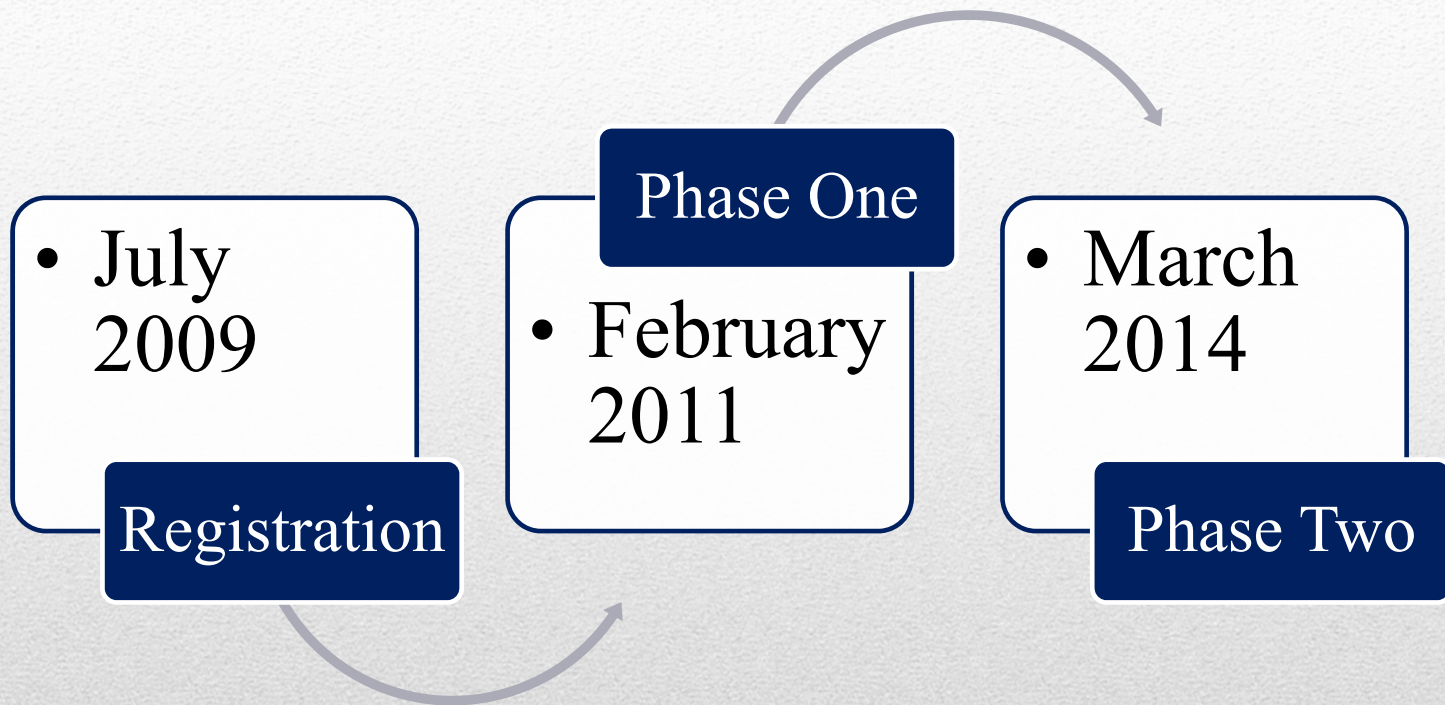
- The scope of our audit included medical marijuana dispensary records for permit applications, business operations tax (BOT), and site observations.



Methodology

- We performed on-site observations to assess the accuracy of BOT remittance and to identify compliance with City Code.
- We reviewed best practices, interviewed staff, and performed analysis and testing of dispensary data.

Audit Objectives, Scope, and Methodologies



Medical Marijuana Dispensary Permit

- City Code *Chapter 17.228 Medical Marijuana Dispensary* requires a dispensary to obtain a conditional use permit (CUP).
- City Code *Chapter 3.08 Business Operations Tax* requires all medical marijuana dispensaries to pay a four-percent business operations tax (BOT).
 - Chapter 3.08.290 states that “[if] the administrator has reasonable cause to believe the return or returns of the amount of tax required to be paid to the city by any person under this article is erroneous, he or she may compute and determine the amount required to be paid.”
- The medical marijuana dispensaries are subject to Community Development Department’s unannounced site inspections.
- The medical marijuana dispensaries are subject to financial audits by MuniServices, LLC, a contractor that performs revenue audits on behalf of the City.

Additional Requirements

Number of Dispensaries Per Council District

District 1 – 0

District 2 – 8

District 3 – 3

District 4 – 6

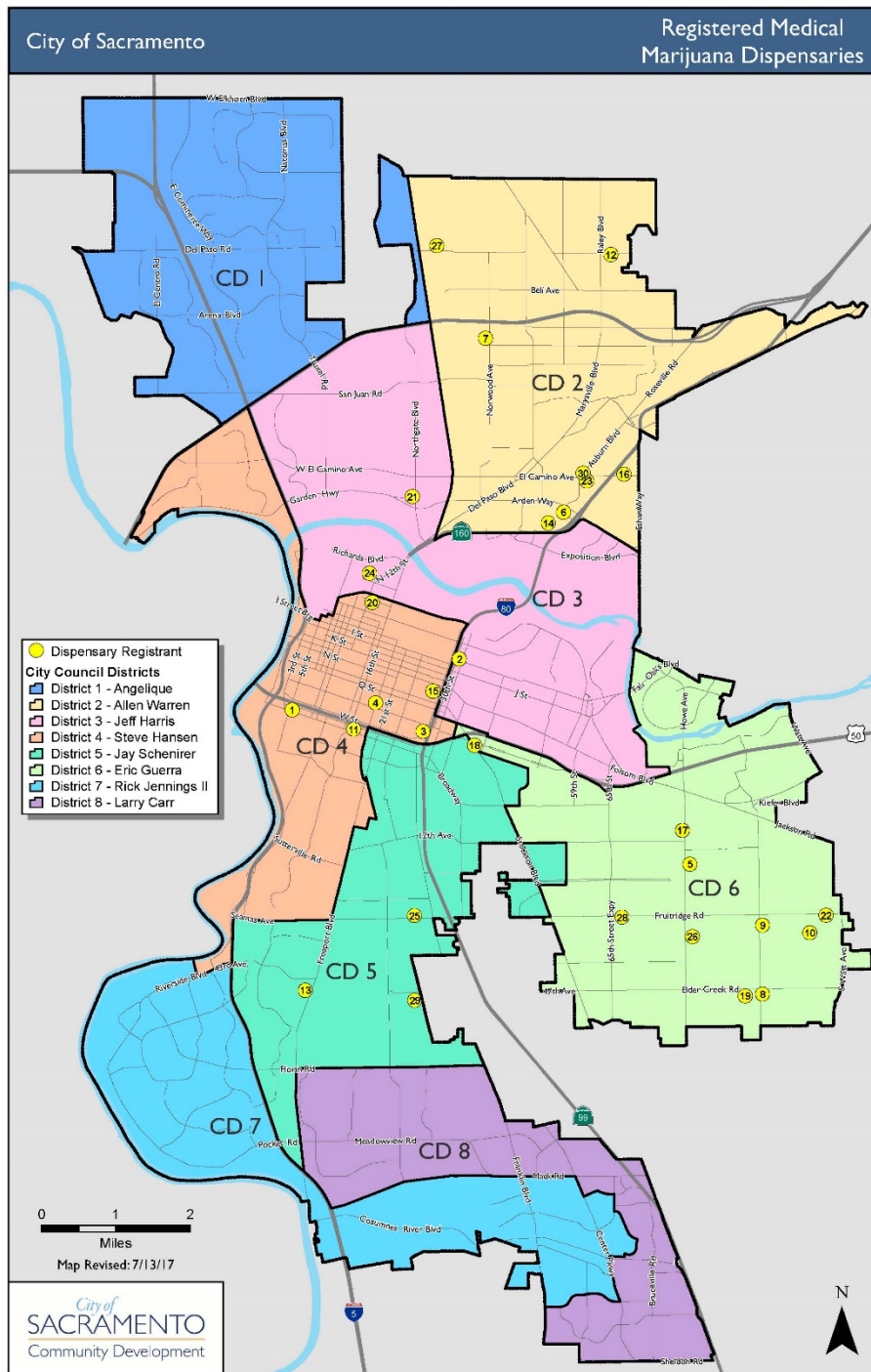
District 5 – 3

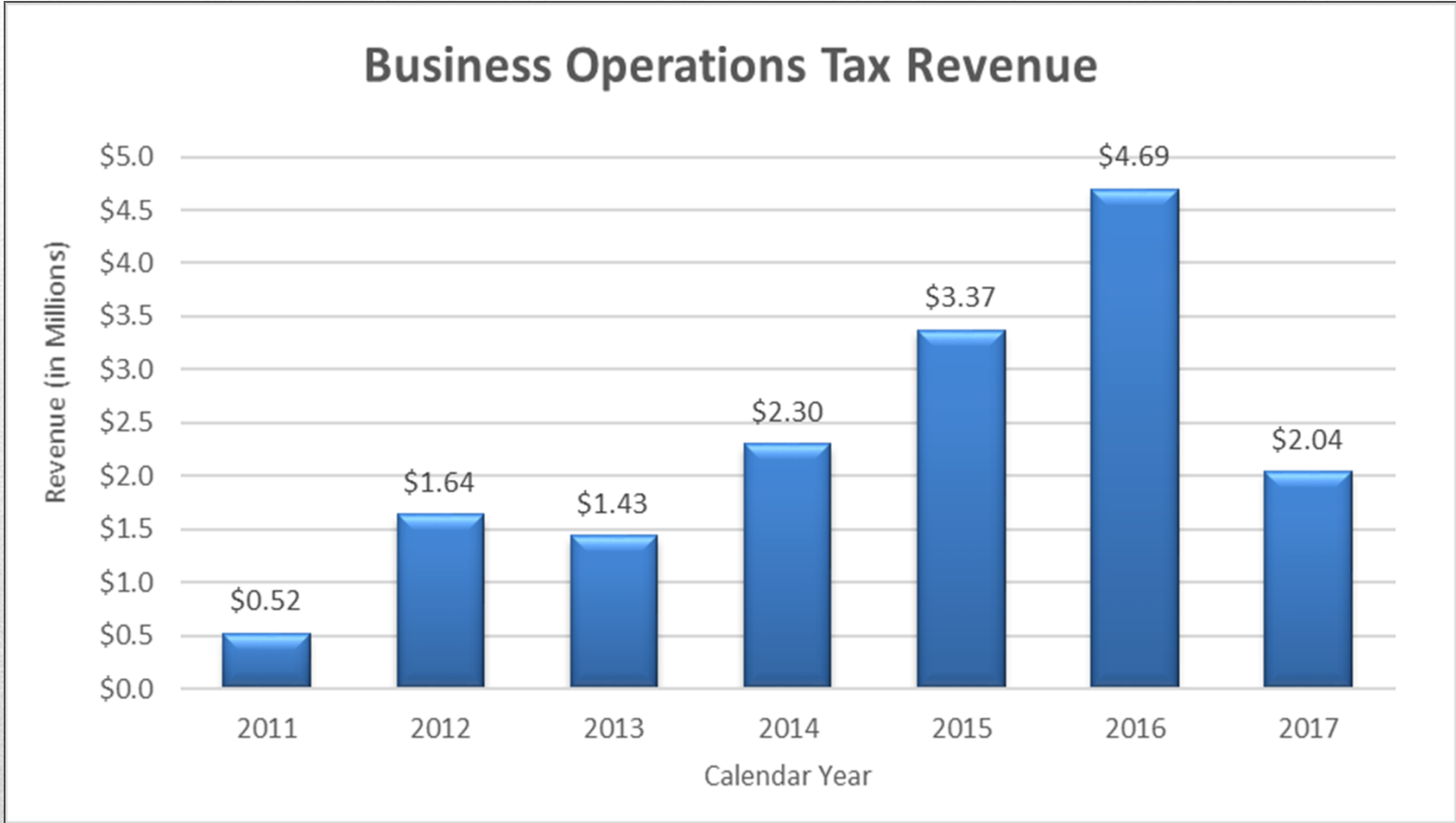
District 6 – 10

District 7 – 0

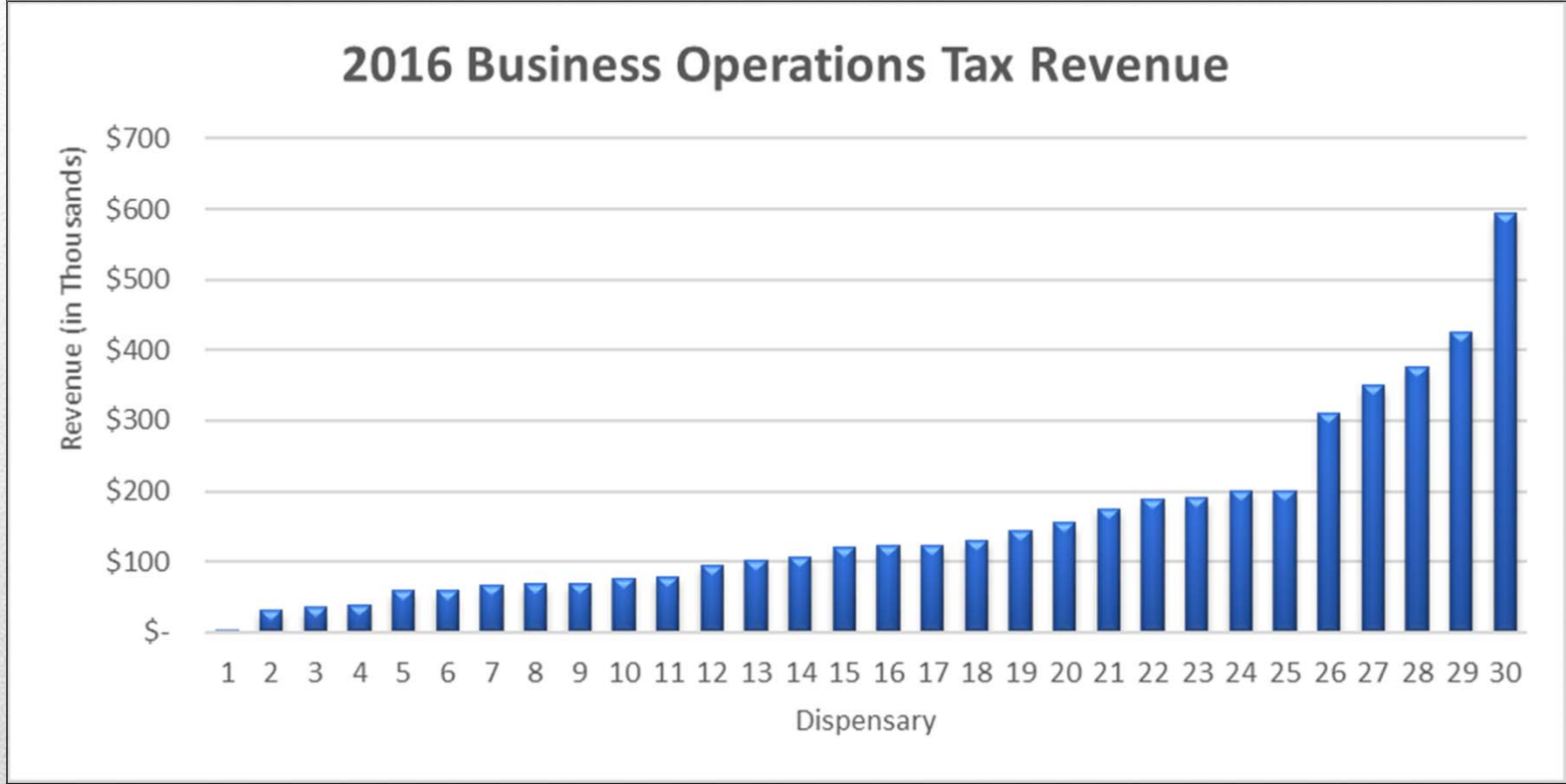
District 8 – 0

Medical Marijuana Dispensary Locations

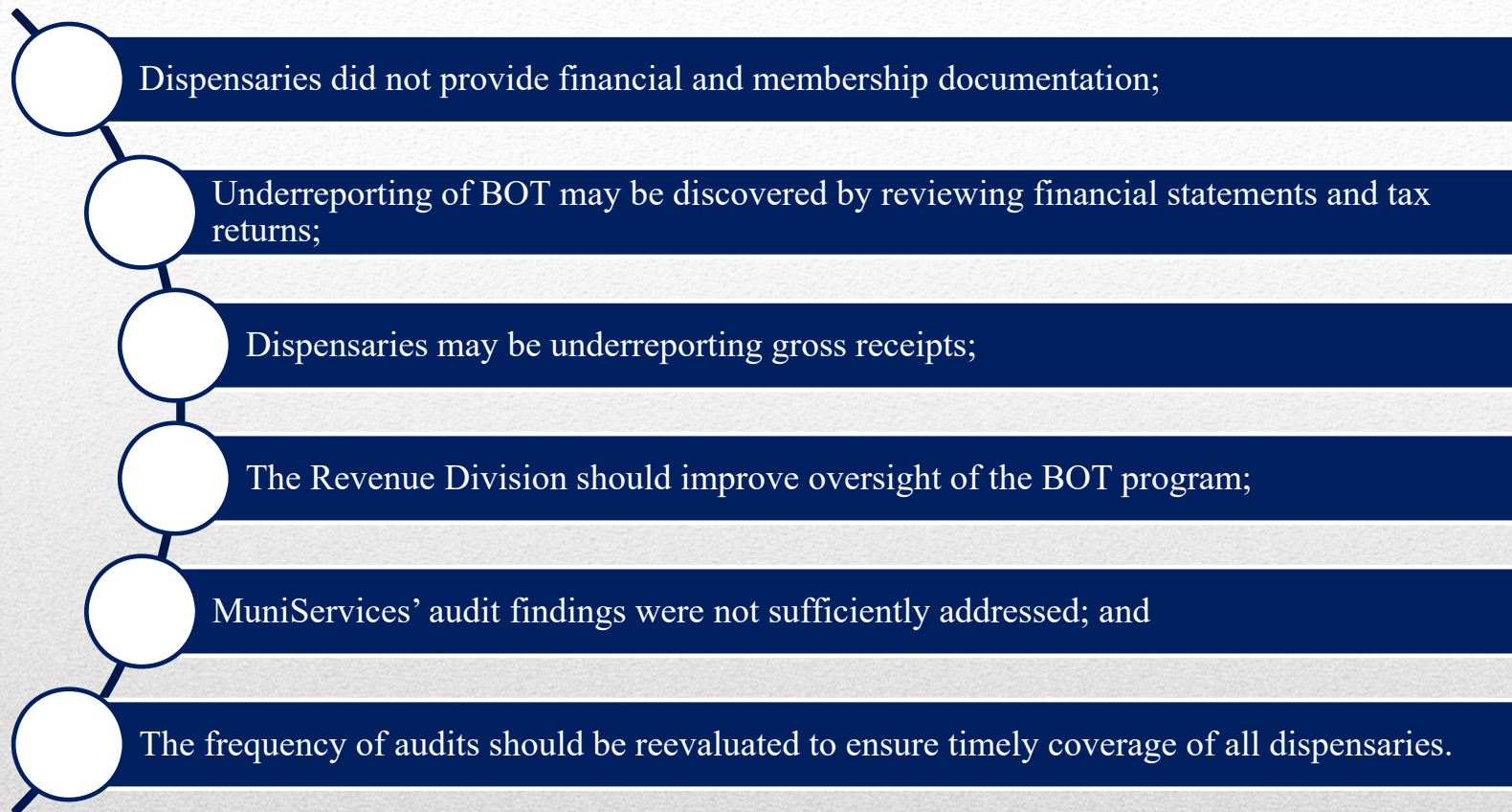




BOT Revenue by Calendar Year



2016 BOT Revenue by Dispensary



Finding 1: The Revenue Division Could Improve its Monitoring of the BOT Collection Process to Better Detect Underreporting

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

* Asterisks indicate that multiple attempts to deliver the letters were unsuccessful.

Results of Requests for Financial and Membership Documentation

STATE BOARD OF EQUALIZATION
SALES AND USE TAX APPEAL

1 CALIFORNIA STATE BOARD OF EQUALIZATION
2 APPEALS DIVISION BOARD HEARING SUMMARY
3 In the Matter of the Petition for Redetermination)
4 Under the Sales and Use Tax Law of:)
5 DURMAN, INC., Account Number SR SO 101-163449¹
6 Case ID 605242
7 Petitioner Van Nuys, Los Angeles County
8 Type of Business: Medical marijuana dispensary
9 Audit period: 11/15/08 – 06/30/11
10 Item Disputed Amount
11 Unreported taxable sales \$1,280,851
12 Negligence penalty \$ 12,174
13 As determined Tax \$160,974.86 Penalty \$16,097.54
14 Post-D&R adjustment - 39,235.30 - 3,923.55
15 Proposed redetermination, protested \$121,739.56 \$12,173.99
16 Proposed tax redetermination \$121,739.56
17 Interest through 04/30/16 45,459.95
18 Negligence penalty 12,173.99
19 Total tax, interest, and penalty \$179,373.50
20 Payments - 747.00
21 Balance Due \$178,626.50
22 Monthly interest beginning 05/01/16 \$ 604.96
23 This matter was scheduled for Board hearing in June 2015, but it was postponed for settlement
24 consideration. It was then rescheduled for hearing in February 2016, but petitioner did not respond to
25 the Notice of Hearing, and the matter was scheduled for decision on the nonappearance calendar in
26 March 2016. Subsequently, petitioner filed a late response to the hearing notice and the matter was
27 rescheduled for hearing.
28 ¹ The account number was changed from SR AC 101-163449 to SR SO 101-163449 in February 2014 when the account
was moved from the Van Nuys District office to the Santa Clarita District office.
Dorman, Inc. -1-

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Durman, Inc.

-1-

STATE BOARD OF EQUALIZATION SALES AND USE TAX APPEAL	1 UNRESOLVED ISSUES		
	2 Issue 1: Whether any additional adjustments to the amount of unreported taxable sales are		
	3 warranted. We find that no additional adjustments are warranted.		
	4 Petitioner operated a dispensary primarily selling medical marijuana, but also selling pipes,		
	5 bongs, lighters, and other smoking accessories, from November 15, 2008, until its seller's permit was		
	6 revoked, effective September 30, 2011. During a visit by staff of the Board's Statewide Compliance		
	7 and Outreach Program (SCOP) to petitioner's business location on October 20, 2009, petitioner stated		
	8 that it served 15 customers per day, on average, and that each customer spent an average of at least		
	9 \$50. Based on petitioner's statements, the SCOP staff estimated quarterly sales of \$68,250 (\$50 per		
	10 customer x 15 customers per day x 7 days x 13 weeks), which substantially exceeded petitioner's		
	11 reported sales of \$6,191 for the second quarter of 2009. Given the discrepancy between estimated and		
	12 reported sales amounts, the SCOP staff referred the case for an audit.		
	13 For audit, petitioner provided customer sign-in sheets for the period February 14, 2009, through		
	14 June 30, 2009, a copy of a commercial lease agreement for a three-year period from November 2010		
	15 through October 2013, and a Tenant Ledger. In the absence of any sales records, the Sales and Use		
	16 Tax Department (Department) decided to establish audited taxable sales based on observation tests.		
	17 From an outside location, the Department observed people entering and leaving petitioner's business		
	18 location for one hour on each of four days in March 2011, and noted that each person entering the store		
	19 left after approximately 15 minutes with a white paper bag. The Department concluded that petitioner		
	20 sold merchandise to each person entering the store during the observation, and computed an average of		
	21 five sales per hour. Based on petitioner's accountant's estimate that each sale averaged \$35, the		
	22 Department computed audited taxable sales of \$175 per hour (5 sales x \$35). The Department		
	23 multiplied 73 hours of operation for one week by 52 weeks to compute 3,796 annual operating hours,		
	24 and multiplied that amount by \$175 to compute audited annual taxable sales of \$664,300. The		
	25 Department then multiplied audited quarterly taxable sales of \$166,075 (\$664,300 ÷ 4) by 10 quarters		
	26 to establish audited taxable sales of \$1,660,750 for the period January 1, 2009, through June 30, 2011,		
	27 and added audited taxable sales of \$83,038 (\$166,075 ÷ 2) for the period November 15, 2008, through		
	28 December 31, 2008, to establish audited taxable sales of \$1,743,788 for the audit period. However, as		

Durman, Inc.

-2-

California State Board of Equalization (BOE)


Appeals Hearing Case ID 605242

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

Comparison of Gross Receipts Based on Auditor's Observation to Dispensary's Self-Reported Gross Receipts

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

Comparison of Unadjusted and Adjusted Gross Receipts from July 2011 to April 2017

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

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

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

*Asterisks indicated items we were not able to observe because the dispensary was not open or we were denied access to those areas.

Results of Surprise Inspections

- Florin Wellness Center Inc. sold marijuana to a patient with an expired medical marijuana recommendation.
- Greenstone Biomass P.O.D. appeared to participate in marijuana delivery services.
- An employee of Metro Health Systems, Inc. appeared to consume marijuana on site.
- Sacramento Community Cannabis Collective sold 50 marijuana plants to one patient, which exceeds the State's established guidelines that allows each patient to possess up to 12 immature plants.

Additional Observations

Develop a risk-based enforcement program that identifies high risk violations and implement a follow-up process to ensure violations are resolved.

Consider imposing penalties to encourage timely compliance with City Code.

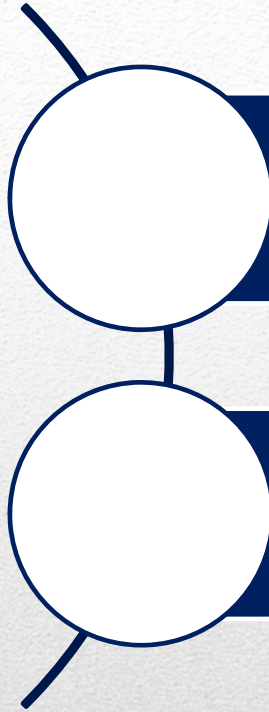
Engage the Office of the City Auditor to perform inspections at the All About Wellness dispensary.

Reevaluate the language in the City Code, and if necessary, strengthen the Code to make it clear that the City has the legal right to enter and inspect dispensaries.

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

Follow up on Community Health Solutions to determine if the dispensary is operating.

Finding 2 Recommendations



The Revenue Division's review process lacks controls to ensure compliance with permit application requirements; and

The Revenue Division could better document dispensary management member, location, and entity name changes.

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

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

Define and communicate to the dispensaries the documents needed to substantiate changes.

Finding 3 Recommendations



Thank you
